Nos. 78-606 and 78-607

In the Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, ET AL.,
Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

JOINT APPENDIX FOR RESPONDENTS

California Public Utilities Commission, City & County of San Francisco, City of Los Angeles and City of San Diego.

THE JAMES H. BARRY CO. 170 SOUTH VAN NESS SAN FRANCISCO CA 94103

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APPENDIX A

[S.F. No. 22794. In Bank. Nov. 26, 1971.]

CITY AND COUNTY OF SAN FRANCISCO, Petitioner, v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Real Party in Interest.

[S.F. No. 22793. In Bank. Nov. 26, 1971.]

CONSUMERS ARISE NOW et al., Petitioners, v.
PUBLIC UTILITIES COMMISSION, Respondent;
PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Real Party in Interest.

(Consolidated Appeals.)

SUMMARY

At a time when a public utility had an option to, but did not, use accelerated depreciation on its federal tax returns, the Public Utilities Commission, for rate making purposes, imposed imputed accelerated depreciation with flow-through on it. The utility continued to use straight line depreciation and, before the instant rate making proceeding, the option was rendered unavailable to the utility by a federal tax law amendment. In the instant proceeding, the commission, in making its decision, noted that in the light of the unavailability of the option, it would be futile to consider the merits of adhering to the procedure adopted in the prior decision.

In proceedings to review, the Supreme Court annulled on the ground that the commission's refusal to consider the merits of adhering to the imputed acceleration with flow-through procedure constituted an abuse of discretion. The court observed that the commission could properly find that tax computations on the straight line basis involved an unreasonable expenditure arising out of an imprudent determination by the utility in not exercising the option when it was available, and that the decision, in its present form, gives the utility the benefit of acceler-

ated depreciation without flow-through, and, in effect, requires the ratepayers to contribute capital to the utility. (Opinion by Peters, J., expressing the unanimous view of the court.)

HEADNOTES

Classified to McKinney's Digest

(1) **Public Utilities and Services § 33—Basis of Rate Fixing—Income Tax as Expense.**—Income tax expense must be considered by the Public Utilities Commission in establishing a utility's cost of service in rate making proceedings.

(2) **Public Utilities and Services § 1—Public Utilities Act—Purpose.**—The primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination.

(3) **Public Utilities and Services § 33—Basis of Rate Fixing—Factors Considered — Disallowance of Expenses.** — The Public Utilities Commission has power to prevent a utility from passing unreasonable costs for materials and services onto the ratepayers by disallowing expenditures that the commission finds unreasonable.

(4) **Public Utilities and Services § 31—Rates or Charges for Services—Control Over Accounting Practices.**—The Public Utilities Commission has power to prevent a utility from resorting to accounting practices that result in unreasonably inflated tax expense.

(5a, 5b) **Public Utilities and Services § 33—Rates or Charges for Service—Basis of Rate Fixing—Factors Considered—Effect of Failure to Exercise Depreciation Option.**—In a proceeding involving determination of the cost of service of a utility which had used straight line depreciation but which had, in a prior decision by the Public Utilities Commission, been subjected to imputed accelerated depreciation with flow-through in recognition of an option in the federal tax laws, the commission abused its discretion in

refusing to consider continuation of the accelerated depreciation procedure notwithstanding that the option had been rendered unavailable to the utility at the time of the instant proceeding by a tax law amendment, where the commission could not properly find that tax computations on the straight line basis involved an unreasonable expenditure resulting from an imprudent management determination by the utility in not electing to file on the basis of accelerated depreciation when it had an option to do so, and where the effect of the decision in the instant proceeding was to give the utility the benefit of accelerated depreciation without flow-through, and to require the ratepayers to contribute capital to the utility.

(6) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Requiring Ratepayers to Provide Utility With Capital.**—Requiring ratepayers to put up the capital for a utility system is contrary to the basic principle of utility rate setting.

(7) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Basic Principle.**—The basic principle of utility rate setting is to establish a rate will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use.

(8) **Public Utilities and Services § 33—Rates and Charges for Service—Basis of Rate Fixing—Factors Considered—Improper Tax Expenses.**—By permitting a utility to include in its cost a charge for federal taxes greatly in excess of its actual federal tax expense, the Public Utilities Commission deviated from the basic principle of utility rate settng calling for the establishment of a rate that will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use.

(9) **Public Utilities and Services § 32—Rates or Charges for Service—Fixing and Modifying Rates—Depreciation Procedure—Due Process.**—The continuation of imputed accelerated depreciation with flow-through for a utility, as adopted in a prior decision of the Public Utilities Commission rendered at a time when the utility had an option to, but did not, use accelerated depreciation on its federal tax returns, would not violate due process despite a subsequent federal tax law amendment rendering the option unavailable to the utility at the time of the instant decision, where the only effect of the amendment was to remove an option which the utility had already rejected, so that the effect of the continuation would be merely to require the utility to do that which it had freely chosen to do.

COUNSEL

Thomas M. O'Connor, City Attorney, Milton H. Mares, Deputy City Attorney, and William F. Bourne for Petitioner in No. 22794.

Garret Shean, in pro. per., and William M. Bennett for Petitioners in No. 22793.

Mary Moran Pajalich and Timothy E. Treacy for Respondents.

Warren A. Palmer as Amicus Curiae on behalf of Respondents.

Pillsbury, Madison & Sutro, John A. Sutro, Noble K. Gregory, George H. Eckhardt, Jr., and Richard W. Odgers for Real Party in Interest.

OPINION

PETERS, J.—These are consolidated proceedings to review Decision No. 77984 of the Public Utilities Commission of the State of California. The decision provides that the Pacific Telephone and Telegraph Company (Pacific) may use accelerated depreciation with the normalization method of accounting as defined in subsection *(l)* (2) (B) of section 167 of the In-

ternal Revenue Code and that, if it elects to do so, the commission, for rate making purposes, will compute Pacific's tax expense on the basis of straight line depreciation for the purpose of establishing its cost of service and will give recognition to the normalization tax reserve in determining rate base. The decision was made effective immediately.[1]

It appears that the general approach employed by the commission for determining what constitutes permissible rates is to determine for a "test period" the costs and expenses which can be attributed to providing the service, the rate base of the utility (value of property devoted to public use), and the reasonable rate of return to be allowed the utility on its rate base. The "test period" costs, expenses, and rate base are then adjusted to allow for the effect of various known or reasonably anticipated changes. By adding the adjusted costs and expenses to the rate of return (in recent years between 5 and 8 percent) multiplied by the rate base, as adjusted, the necessary gross revenues are determined, and the rates are then fixed to produce such gross revenues. (See *Pacific Tel. & Tel. Co.* v. *Public Util. Com.*, 62 Cal.2d 634, 643-645 [44 Cal.Rptr. 1, 401 P.2d 353].) Under this system an increase in a cost item will ordinarily be reflected as an increase in the rates, and a reduction in the rate base will produce a reduction in the rates. However, the increase in cost will be reflected in its full amount in the rates, while the reduction in the rate base will be reflected only to the extent of the reasonable rate of return, between 5 and 8 percent of the reduction.

In computing the cost of service for rate making purposes, the utility is allowed to recover its federal income taxes as a cost of business. In computing the federal income tax cost the utility is allowed to deduct depreciation, and the greater the depreciation for tax purposes (all other things being equal) the

1. The decision was by Chairman J. P. Vukasin, Jr., and was signed by Commissioners William Symons, Jr., and Vernon L. Sturgeon. Chairman Vukasin, Jr., also filed a concurring opinion. Commissioners Thomas Moran and A. W. Gatov dissented.

less the tax liability and the less the necessary rate to recover it.

Since 1954, the federal government has permitted straight line or accelerated depreciation in determining federal income tax liability. Straight line depreciation provides for essentially uniform annual write-offs of a depreciable asset over the life of the asset. Accelerated depreciation provides for larger allowances as expenses than straight line depreciation during the early years of the life of the asset but during later years the depreciation expense attributable to the asset will ordinarily be less than if the straight line method had been used. Because of the relation between depreciation and tax liability, it would follow in *theory* that accelerated depreciation would result in lower tax liability of tax expense in the early years as compared to straight line depreciation but that in subsequent years the tax liability would exceed that had straight line been used and thus lead to higher rates. In theory there would be lower rates in the earlier years under accelerated depreciation but higher rates in later years. However, in *practice*, the tax saving of the earlier years, although in a sense repaid in the subsequent years, does not result in higher taxes and rates in the later years because the utilities tend to increase their investment in plant and equipment every year so that the increased depreciation due to acceleration in any year will more than offset any reduced depreciation due to the effect of accelerated depreciation as to older assets.[2]

Apparently all utilities other than Pacific and General Telephone have used accelerated depreciation in computing and paying their federal income taxes. The commission has in the

2. In the language of the commission majority opinion: "Accelerated depreciation . . . provides for larger than straight-line annual write-offs of a depreciable asset during early years and diminishing annual write-offs during later years of the asset's life. For a given depreciable asset, the total amount written off duing its lifetime would be the same under either depreciation method but the rates of accruals would differ. For a group of assets of different vintages, the diminution of accruals for older plant can be obscured by the larger accruals on newer plant."

past required the utilities using accelerated depreciation to pass on the tax savings to the consumer in the form of lower rates (in computing the cost of service for the purpose of fixing rates, the actual tax liability was used rather than the greater tax liability that would have been due had straight line depreciation been used for tax purposes). This passing on to the consumer of the tax savings is called "flow-through."

Pacific and General Telephone, unlike other utilities, have refused to use accelerated depreciation in filing their income tax returns. On November 6, 1968, in Decision No. 74917 the commission determined that Pacific's management was imprudent in not electing to take accelerated depreciation for income tax purposes. The commission concluded that it could not compel Pacific to take the accelerated depreciation on its federal income tax return, but it held that for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving would be flowed-through to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.) Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation.

In section 441 of the Tax Reform Act of 1969, Congress amended section 167 of the Internal Revenue Code to limit the use of accelerated depreciation by utilitis in determining income tax liability. Subsection *(l)* (2) provides: "In the case of any post-1969 public utility property, the term 'reasonable allowance' [for depreciation] as used in subsection (a) means an allowance computed under—

"(A) a sbsection *(l)* method [straight line depreciation (see Int.Rev. Code, § 167, subs. *(l)* (3) (F))],

"(B) a method otherwise allowable under this section [such as accelerated depreciation] in the taxpayer uses a *normalization* method of accounting, or

"(C) the applicable 1968 method, if, with respect to its pre-

1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period."[3] (Italics added.)

Subsection *(l)* (3) (G) defines normalization: "In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purpose of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The commission permitted argument by interested parties in this matter. However, it refused to accept any evidence and struck evidence previously received (some correspondence between Pacific and the Internal Revenue Service).

The commission found that it had in its 1968 decision imputed to Pacific for tax purposes accelerated depreciation with flow-through pointing out that Pacific had an option to use accelerated depreciation; that Pacific had used straight line depreciation in its income tax returns through the year 1969, and that under the Tax Reform Act of 1969 could accelerate depreciation for tax purposes only if it normalized. The commission concluded that it would now declare that it intended

3. All utilities other than Pacific and General Telephone, are eligible to come under clause (C) and thus continue to use accelerated depreciation for tax purposes with flow-through of the tax savings to the consumer. It would seem that Pacific and General Telephone may not resort to the option provided by clause (C) because they did not use accelerated depreciation in 1968 or in their July 1969 accounting period.

to use normalization of taxes in setting Pacific's rates so that Pacific could commence acceleration under subsection *(l)* (2) (B) with regard to its 1970 taxes.

The majority opinion reasoned that the commission could not continue the existing method of imputing accelerated depreciation. The commission said of its 1968 ruling: "The imputation of accelerated depreciation with flow-through did not deprive Pacific of its property without due process because there was then no legal restriction against Pacific's changing to accelerated depreciation with flow-through and paying essentially those income taxes that had been allowed in the decision. [¶] That no longer is the case. If we now were to attempt to impute accelerated depreciation with flow-through for setting rates in this proceeding, the law clearly would preclude Pacific from actually using accelerated depreciation in filing its federal income tax returns. We thus would be assuming lower taxes than Pacific would be required by law to pay. . . . *Since accelerated depreciation with flow-through is no longer an option available to Pacific under federal law, it would now be futile to consider the relative merits of flow-through and normalization.*" (Italics added.)

We have concluded that the commission has erred in refusing to consider the merits of adhering to the 1968 method of *imputing* accelerated depreciation with flow-through and that for this reason its decision must be annulled. Under the 1968 method Pacific filed its federal income tax return on the basis of straight line depreciation but for rate purposes the tax expense was calculated on the basis of accelerated depreciation and the savings flowed-through to the ratepayers. Subsection *(l)* (2) (A), quoted above, provides that the utility may use straight line depreciation in its federal income tax returns, and there are no conditions to the resort to straight line.

The commission and Pacific do not dispute that there are no conditions to the use of straight line depreciation in the subsection. Their position is that, if straight line depreciation is

used in filing the income tax return, due process requires that its tax expense for rate-making purposes be its actual tax expense and that it would be a denial of due process to *impute* accelerated depreciation in computing its tax expense for rate making purposes.

(1) Income tax expense must be considered by the commission in establishing Pacific's cost of service. (See *Galveston Elec. Co.* v. *Galveston*, 258 U.S. 388, 399 [66 L.Ed. 678, 684, 42 S.Ct. 351]; *Dyke Water Co.* v. *Public Utilities Com.*, 56 Cal.2d 105, 127 [14 Cal.Rptr. 310, 363 P.2d 326].) **(2, 3)** However, "the primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination; and the commission has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the commission finds unreasonable. (*Pacific Tel. & Tel. Co.* v. *Public Utilities Com., supra* 34 Cal.2d 822.)" (*Pacific Tel. & Tel. Co.* v. *Public Util. Com., supra,* 62 Cal.2d 634, 647.)

(4) The same rule applies where the utility resorts to accounting practices which result in unreasonably inflated tax expense. It was on the basis of this rule that the commission in 1968 determined to *impute* accelerated depreciation to Pacific in determining its tax expense. In Decision 74917, the commission stated that for the period 1954-1967 Pacific's taxes would have been $225,000,000 less if it had used accelerated depreciation for the entire period, and that in other words, "Pacific's ratepayers might have had to pay some $450,000,000 less if Pacific had availed itself of the lawful option of using accelerated depreciation for tax purposes. . . ."[4] If it had been

4. Apparently the commission assumed a 50 percent tax rate.

The fact that the necessary increase of revenue is approximately double the tax expense suggests the reason why Pacific refused to shift to accelerated depreciation with flow-through when it could do so.

On the other hand, there is substantial reason, other than benefit to its ratepayers, for a utility to voluntarily switch from straight line depreciation to accelerated depreciation with flow-through. Ordinarily there will be some period during which the utility pays reduced taxes on the basis of

using accelerated depreciation, the savings in the test year would have been $27,400,000 with a resultant savings effect on gross revenues of approximately $57,000,000. (69 Cal. P.U.C. 53, 61-62.) The commission found that a "true tax saving" will continue to result from accelerated depreciation for at least as long as plant additions equal or exceed plant retirements and pointed out that without exception Pacific's witnesses foresee a continuing growth of plant, one estimate involving a doubling of plant in 10 years and compounding of growth during the next 20 years.[5] (*Id.* at p. 62.)

The commission found that management's discretion has exceeded a reasonable and prudent course respecting income taxes to the detriment of the public interest and that it was fair and reasonable and in the public interest to compute Pacific's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant additions in the test year. (*Id.*, at p. 90.)

(5a) Under its general power to prevent a utility from passing on to its ratepayers unreasonable costs, the commission in the instant proceeding, notwithstanding the change in the federal tax statute, could properly find that the federal income tax calculated on the basis of straight line depreciation involved an unreasonable expense and that the unreasonable expense due to such calculation was due to an imprudent management decision.

Although prior to the statutory change Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its

accelerated depreciation before the commission adjusts rates to reflect the reduced payments. During that period the savings due to accelerated depreciation will inure to the benefit of the utility.

5. It should also be recognized that in the unlikely event the rate of investment should decrease, there could be a net increase in a given year but that so long as the utility remains a going concern and must continue with some investment there will be an overall tax saving while it continues accelerated depreciation. In other words, so long as there is a single dollar of new investment, there will be a tax deferral.

original imprudent determination to pay federal income taxes on a straight line depreciation basis and its obstinacy after the 1968 commission decision in adhering to the imprudent determination.

As pointed out in footnote 3, any utility which used a flow-through method of accounting for its July 1969 accounting preiod may continue to do so under clause (C) of subsection (2). There is no suggestion in the majority opinion or the two dissenting opinions that, if Pacific were eligeble for accelerated depreciation and flow-through in paying its federal taxes, Pacific would not be reqiured to compute its federal tax expense on such basis for rate making purposes.[6] It thus seems clear that the only reason it is not treated in this manner is that in prior years it imprudently refused to file returns on a basis of accelerated depreciation and then after the 1968 decision obstinately continued in its imprudent refusal.

The effect of Pacific's refusal in 1968 to switch to accelerated deprication was to cast a significant burden on itself. By refusing to switch to accelerated depreciation in filing its income tax returns after it was aware that such depreciation would be imputed to it for rate making purposes in calculating federal tax expense, Pacific in essence placed itself in the position of paying a large income tax bill, part of which was unnecessary and was not to be recovered in higher rates. As to that part, Pacific in a sense placed itself in the position of having to raise additional funds, either debt or investment. Nevertheless, Pacific chose to do so.

It should also be pointed out that the effect of the instant decision is to permit Pacific to include as an expense for rate making purposes a large amount of federal income taxes which it will not be required to pay in the foreseeable future. Although the majority opinion ignores this matter, the concurring opinion

6. The concurring opinion of Chairman Vukasin, Jr., suggests a contrary view.

and the two dissenting opinions recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will "provide a source of interest-free capital." We do not know how much capital will be provided, but the dissenting commissioners estimate that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars. Commissioner Moran in his dissenting opinion states that if the ratepayers are required to put up the capital for the telephone system, it "is indeed a step toward socialism and logically could lead ultimately only to government ownership of the telephone system. . . ."

(6) Although Commissioner Moran may be overstating the matter, it is clear that requiring ratepayers to put up the capital for the telephone system is contrary to the basic principle of utility rate setting. **(7)** The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. (*Pacific Tel. & Tel. Co.* v. *Public Util. Com., supra,* 62 Cal.2d 634, 644-645.) **(8)** By permitting Pacific to include in its costs a charge for federal taxes greatly in excess of its actual federal tax expense, the commission is deviating from this basic principle. We realize that the 1968 commission decision also deviated from the basic principle by refusing to permit Pacific to include in its costs all of its tax expense, but this deviation was based on Pacific's imprudent management.

(5b) It should also be pointed out that the effect of the instant decision is to reward Pacific for its imprudent management as compared to other utilities which prudently had adopted accelerated depreciation and flow-through prior to August 1969. Apparently, these utilities will continue to be required to flow-through the benefits of accelerated depreciation to the ratepayers, whereas Pacific will be allowed to use

accelerated depreciation without requiring flow-through, thus retaining most of the benefits for itself.

In the circumstances, we are satisfied that, in the light of Pacific's past imprudence, the commission could reasonably have ordered Pacific to continue the accounting practices established in the 1968 decision and that the commission abused its discretion in expressly *refusing to consider* imputed accelerated depreciation and flow-through as established in the 1968 decision.

(9) The argument that in the light of the federal tax amendment there will be a denial of due process in continuing the 1968 treatment falls on its face in view of Pacific's conduct. Prior to the federal tax amendment and after the 1968 decision of the commission, Pacific could have elected to change its accounting procedures in filing its returns and thereby saved substantial tax expense. Pacific, however, chose not to do so. The only effect of the federal tax amendment is to take away the option which Pacific had already rejected. Requiring Pacific to do that which it had freely chosen to do cannot be said to be a denial of due process. In other words, after the 1968 decision, Pacific, if it chose could have opted for accelerated depreciation on its tax return. It did not do so. Had it done so, Pacific could have uesd accelerated depreciation with flow-through. Now the option to switch to accelerated depreciation and flow-through has been terminated, but even assuming the absence of the option is a matter to consider by the commission, it does not mean that continuation of the 1968 treatment will result in a denial of due process.

For failure to consider lawful alternatives in calculation of federal income tax expense, the decision of the commission must be annulled. (Cf. *Northern California Power Agency* v. *Public Util. Com.*, 5 Cal.3d 370, 380 [96 Cal.Rptr. 18, 486 P.2d 1218].) Upon further consideration the commission should consider whether to adhere to the 1968 method of determining

federal income tax expense and whether to adopt the accelerated depreciation and normalization method adopted by the decision before us. Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax are either harsh on the utility or the ratepayers, the commission may also consider alternative approaches which strike a balance between these two extremes.

The 1968 method of imputed accelerated depreciation and flow-through is favorable to the ratepayer but harsh on Pacific. In terms of the 1967 figures, as compared to straight line depreciation for tax purposes, this method would save the ratepayer 54 million dollars but Pacific would in a sense be penalized 27 million dollars. The method adopted by the decision before us is harsh on the ratepayer who under the 1967 figures will be compelled to lose most of the 54-million-dollar saving but is beneficial to Pacific which will be permitted rates including the 54 million.

These two methods are extremes when compared to the nontelephone utilities which, having switched to accelerated depreciation with flow-through prior to 1970, may continue with that method and permit the ratepayers the consequent reduction without being compelled to pay the tax on the basis of straight line depreciation. Although the method open to the nontelephone utilities is not open to Pacific, the commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in the light of current federal income tax statutes.

Both of the extreme methods involve a fictitious change of federal tax expense. The 1968 method deliberately understates the actual tax expense on the basis of the imprudent management of Pacific. The method adopted in the decision before us deliberately overstates the actual tax expense in order to nor-

malize. Since a fictitious figure must be used under either method, it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections.

The decision is annulled.

Wright, C. J., McComb, J., Tobriner, J., Mosk, J., Burke, J., and Schauer, J.,* concurred.

The petition of the real party in interest for a rehearing was denied December 23, 1971. Sullivan, J., did not participate therein.

[S.F. No. 23215. In Bank. Dec. 12, 1975.]

CITY OF LOS ANGELES et al., Petitioners, v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
PACIFIC TELEPHONE AND TELEGRAPH
COMPANY, Real Party in Interest.

[S.F. No. 23237, 23257. In Bank. Dec. 12, 1975.]

CITY OF LOS ANGELES et al., Petitioners, v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
GENERAL TELEPHONE COMPANY OF
CALIFORNIA, Real Party in Interest.

SUMMARY

In three telephone rate cases, the Public Utilities Commission determined that it lacked legal authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses. It refused to consider its staff's recommendation of a rate setting system which included a formula by which rates would be automatically adjusted annually on the basis of savings to the utilities through their use of accelerated depreciation as permitted under federal tax law. Because of its determination that it could not adopt the annual adjustment plan, the commission stated that it was compelled to set a rate which would create a windfall for the telephone companies to the detriment of the rate payers.

The Supreme Court affirmed the commission's order except as to the portion relating to treatment of tax expenses, and as to that portion it annulled and remanded the matter for further proceedings consistent with the opinion. The court held that the commission possesses the power to implement an annual adjustment scheme. In rejecting a contention that such a system was precluded by Pub. Util. Code, § 728, which provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts," the court held erroneous the conception that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges. It was pointed out that the commission's position was contrary to its long standing and unchallenged practice of including adjustment clauses in power company tariffs to take care of disproportionate variations in fuel costs as well as to judicial precedent and the purpose behind the statute's hearing requirement, which is to air the policy considerations behind various rate proposals and to establish controverted facts. In further holding that use of a tariff involving an annual adjustment does not deny due process to an affected utility, the court pointed out that a full hearing is required before the promulgation of any general rate tariff, that the utilities involved have the opportunity at that time to inspect and challenge any formula proposed through testimony, briefs, exhibits, and oral argument, that such an adjustment clause would operate on figuers which the utilities had placed in their account books, in accordance with a system

*Retired Associate Justice of the Supreme Court sitting under assignment by the Chairman of the Judicial Council.

as to which they had received another, prior hearing, and with full knowledge that the commission would employ them in connection with the annual adjustment clause, and that an affected company is entitled to apply for a rate increase pursuant to Pub. Util. Code, §§ 454, 455, should application of the adjustment clause result in a rate below its authorized return. (Opinion by Tobriner, J., expressing the unanimous view of the court.)

HEADNOTES

Classified to California Digest of Official Reports, 3d Series

(1a, 1b) **Public Utilities § 11—Public Utilities Commission—Bases of Rate Fixing—Factors Considered—Validity of Automatic Annual Adjustment Clause.**—In telephone rate setting proceedings, the Public Utilities Commission erred in determining that consideration of a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected companies was precluded by Pub. Util. Code, § 728, which provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts." Construing the statute to mean that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges is unwarranted and is contrary to the commission's long standing and unchallenged practice of including adjustment clauses in power company tariffs and to judicial precedent. Moreover, the purpose behind the statute's heading requirement is to air the policy considerations behind various rate proposals and to establish controverted facts, and such purpose is not served by a hearing at which the only business at hand is the application of a mathematical formula to a figure definitively established by reference to the utilities' books.

(2) **Statutes § 44 — Construction — Aids — Contemporaneous Administrative Construction.**—Consistent administrative construction of a statute over many years, particularly when it originated with those charged with putting the statutory machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous.

(3a, 3b) **Public Utilities § 11—Public Utilities Commission—Bases of Rate Fixing—Factors Considered—Validity of Automatic Annual Adjustment Clause.**—In telephone rate setting proceedings, the Public Utilities Commission was not precluded by the due process clause of the United States Constitution from considering a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected telephone companies. At the full hearing required by Pub. Util. Code, § 728, before the promulgation of any general rate tariff, the utilities involved have the opportunity through testimony, briefs, exhibits, and oral argument to inspect and challenge any formula proposed, and such an adjustment clause would operate on figures which the utilities had placed in their account books, in accordance with a system as to which they had received another, prior hearing, and with the full knowledge that the commission would employ them in connection with the annual adjustment clause. In addition, an affected company is entitled to apply for a rate increase pursuant to Pub. Util. Code, §§ 454, 455, should application of the adjustment clause result in a rate below its authorized return.

[See **Cal.Jur.2d,** Public Utilities and Services, §§ 28, 59; **Am.Jud.2d,** Public Utilities, § 266.]

(4) **Public Utilities § 10—Pbulic Utilities Commission—Fixing or Modifying Rates—Due Process.**—Within the context of public utility rate regulation, due process is a flexible concept, permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

(5) **Public Utlities § 10—Public Utilities Commission—Fixing or Modifying Rates — Due Process.** — The due process clause of the United States Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom such legislative power has been delegated are free, within the ambit of their statutory authority, the make the pragmatic adjustments which may be called for by particular circumstances, and once a fair hearing has been given, proper findings made, and other statutory requirements satisfied,

the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped.

(6) **Public Utilities § 16—Public Utilities Commission—Orders of Commission—Rehearing.**—The procedure of the Public Utilities Commission in entering an order on rehearing pursuant to Pub. Util. Code, § 1736, of a telephone rate setting proceeding, which repromulgated a tariff as an interim rate subject to refund if it were later found to be erroneous, was proper, though the commission erred substantively in failing to consider a system of yearly automatic rate adjustments to take account of changing federal tax expenses of the affected companies, where the time limit for a rehearing specified by Pub. Util. Code, § 1731, had not expired and the rate set by the commission's original decision had not become final and lawful so as to preclude refunds.

[See **Cal.Jur.2d,** Public Utilities and Services, § 123.]

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OPINION

TOBRINER, J.—In these three telephone rate cases the Public Utilities Commission determined, inter alia, that it lacked legal

authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses. As a consequence, the commission found itself compelled to set a rate which, in its own words, would "create a windfall for [the telephone companies] to the detriment of the ratepayers." (*Re Pacific Telephone & Telegraph Co.* (1974)—Cal.P.U.C.— (Decision No. 83162; slip opn., p. 63).) The commission took this action in spite of our having annulled its previous decisions in this matter "[f]or failure to consider lawful alternatives in calculation of federal income tax expense." (*City and County of San Francisco* v. *Public Utilities Com.* (1971) 6 Cal.3d 119, 130 [98 Cal.Rptr. 286, 490 P.2d 798].) As we explain, we have concluded that the commission does possess the power to implement an annual adjustment scheme, and we accordingly remand these cases in order that the agency may reconsider its action with knowledge of the full scope of its powers.

In addition to this failure to consider lawful alternatives in the treatment of tax expenses, the petitioning cities assert as grounds for annulment: (1) that the commission authorized an unreasonably high rate of return for the two telephone companies in question; and (2) that the commission erred in promulgating an interim rate pending its rehearing of the General Telephone case. As to the first contention, we have concluded that the commission did not exceed the boundaries of its discretion. (Pub. Util. Code, § 1757.) As to the second contention, we show below that the commission regularly pursued its authority.

1. *The background of the present litigation.*

Because these cases spring from the relationship between federal taxing authority and public regulatory power, we must review pertinent developments in these two fields.

An extremely significant element of the operating expenses which a rate-setting agency must consider is that of state and

federal taxes;[1] increased tax deductions decrease a utility's tax bill and with it the revenue it must acquire from its ratepayers. These cases turn on two such tax deductions available to General and Pacific,[2] accelerated depreciation and the Job Development Investment Credit;[3] both of them enable a public utility to reduce its tax expenses, and the efforts of regulatory bodies to pass the benefits of such reduced tax expenses on to the utilities' ratepayers form the backdrop to the instant cases.[4]

Such regulatory efforts are of course mandatory for a state agency charged with insuring that "[a]ll charges demanded or received by any public utility . . . shall be just and reasonable" (Pub. Util. Code, §451) and that "[n]o public utility shall raise any rate . . . except upon a showing before the commission and a finding by the commission that such increase is justified" (Pub. Util. Code, § 454). We therefore examine the background of these cases to determine whether the commission has failed to consider alternative means of dealing with unnecessary tax payments which might be eliminated to the benefit of the ratepayers.

Since 1954, section 167 of the Internal Revenue Code has given business taxpayers several options in computing depreciation deductions from their federal taxes. Thus the utilities in the instant case may, like other businesses, assume that their

1. According to one authority, as of 1967 United States telephone companies spent 23 percent of their total revenue on taxes. (Welch, Cases, Text, and Material on Public Utility Regulation (rev. ed. 1968) p. 440.)

2. We refer in this opinion to the real parties in interest in the instant case, General Telephone Company of California and Pacific Telephone and Telegraph Company, as General and Pacific, respectively.

3. The Job Development Investment Credit (85 Stat. 503, 26 U.S.C. § 46 et seq.), a tax deduction which all parties concede has tax and revenue effects substantially similar to accelerated depreciation and therefore calls for identical treatment, will be included in all subsequent references to accelerated depreciation.

4. In the instant Pacific proceeding the commission indicated that for *1973 alone*, "the difference in gross revenue requirements between" a rate passing tax benefits on to the consumer and one permitting the utilities to retain these benefits "is approximately $23 million." (*Re Pacific Telephone & Telegraph* (1974)—Cal. P.U.C.—, —(Decision No. 83162, slip opn., p. 7).)

depreciable assets wear out at an even rate and deduct the same amount of depreciation for each year of useful life; such an assumption is known as "straight-line" depreciation. Another option, first made available by 1954 amendments to the Internal Revenue Code is "accelerated" depreciation (Int. Rev. Code of 1954, § 167(b) (2)-(4)); using this method the enterprise takes deductions as if the asset in question depreciates more rapidly in the earlier years of its life and more slowly thereafter.[5] A taxpaying utility using accelerated depreciation would deduct the same *total* amount of depreciation over the useful life of the asset as a taxpayer using straight-line methods, but accelerated depreciation permits the largest part of this total to be deducted in the early years of the asset's life.

If one thinks of a single piece of depreciable equipment, such as a desk or typewriter, over the long run it would make no difference which system of depreciation were employed since the utility could write off no more than the total value of the asset in any case. That which holds true for a single asset, however, does not do so for an enterprise considered as an evolving whole. (Bonbright, Principles of Public Utility Rates (1961) pp. 218-223; see *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Com'n.* (5th Cir. 1966) 359 F.2d 318, 328.)

Ratemakers have discovered that if the total enterprise is either expanding or stable, the use of *accelerated depreciation does not merely defer taxes, but eliminates them entirely.* (See *FPC* v. *Memphis Light, Gas & Water Div.* (1972) 411 U.S. 458, 460 [36 L.Ed.2d 426, 430, 93 S.Ct. 1723]; Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.) This effect occurs because in the later years of an asset's life (when

5. In fact, the code and Treasury Regulations permit several different forms of accelerated depreciation, the differences between which are not here relevant; *all* forms of accelerated depreciation result in a deduction larger than that permitted by straight-line methods in the earlier years of the asset's life.

its value as a depreciation deduction has been used up), its place is taken by a *new piece of equipment, which replaces it as a deduction in income tax calculation.* This replacement effect means that the higher depreciation taken in early years does not have to be paid for by lower depreciation in later years; *the tax never catches up.* The result is a net tax savings to any utility using accelearted depreciation.[6]

For a rate-setting agency the comprehension of this counter-intuitive fact has important implications. If the Public Utilities Commission in setting rates were to assume that tax deductions for depreciation under both the straight-line and accelerated methods would yield the same result in the long run, it would, in fact, award the utility a rate windfall. For it would have set rates as if the utility would incur tax expenses *which it would never have to pay.*

In 1960 the California Public Utilities Commission after studying this problem issued a report indicating that it would pass on to ratepayers any savings effected by the adoption of accelerated depreciation and suggesting that the utilities' management elect this method. (*Commission Investigation Regarding Rate Fixing Treatment for Accelerated Amortization and Depreciation for all Utilities,* 57 Cal. P.U.C. 598.)[7]

Pursuant to this recommendation "[a]pparently *all utilities other than Pacific and General Telephone* have used accelerated depreciation." (*City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 124; italics added.) Because "Pacific and General Telephone, unlike other utilities . . . refused to use accelerated depreciation . . . [o]n November 6, 1968, in Decision No. 74917 the Commission determined that Pacific's management was imprudent" in not electing the option and "concluded that . . . for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving your be [passed on] . . . to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.)" (*Id.*)[8]

In 1969, however, Congress amended the Internal Revenue Code.[9] The amendments, some of a highly technical nature, provided that utilities which had not taken accelerated depreciation before 1969 could do so subsequently only if they "compute[d] tehir cost of service, which includes federal income taxes, as if they were using straight-line depreciation. This

6. A respected federal appellate judge has explained the apparently paradoxical tax savings as follows: "Lifetime depreciation on a single item of property is of course the same whether the utility elects straightline or accelerated depreciation. Under conventional accounting principles, therefore, the full amount of the value of the item less salvage would be a deductible expense. Conventional accounting, however, does not take consideration the effect of applying liberalized depreciation to a utility's total assets which are, of course, subject to a continuing cycle of obsolescence and renewal. If the industry is stable or expanding, requiring the utility's *continued reinvestment in plant equal to or in excess of plant retirement,* a program of liberalized depreciation produces true tax savings because there is no reduction in the tax reserve fund [fn. omitted]." (*Alabama-Tennessee Natural Gas Co.* v. *Federal Power Com'n., supra,* 359 F.2d 318, 328 (Wisdom, J.); italics in original.)

The United States Supreme Court has explained that the effect described by Judge Wisdom occurs bcause "the depreciation allowances from additional and replacement equipment offset the declining depreciation allowance on existing property." (*FPC* v. *Memphis Light, Gas & Water Div., supra,* 411 U.S. 458, 460 [36 L.Ed.2d 426, 430]; see also Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.)

7. Economists recognize that accelerated depreciation, when combined with flow-through accounting, encourages timely replacement of needed capital equipment (Defliese, *Changing Accounting Objectives — What About Utilities?* (1972 No. 2) 90 Pub. Util. Fort. 17, 20-21) in the extremely capital-intensive public utility industry (Rudolph, *Depreciation and Changing Price Levels: Specific Problems of Utilities,* in Depreciation and Taxes (Tax Inst. ed. 1959) pp. 80, 80-81) and permits obsolescence to be recognized before rather than after the fact "so that consumers will reap the benefits of progress that much sooner." (Defliese, *supra,* at p. 21.)

8. The commission's ruling corresponded with the conclusions reached by Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making* (1961) 28 U. Chi. L. Rev. 629, 632: "The public interest requires that utilities maintain their costs at the lowest level consistent with proper service to the consumer. Accordingly, if the flow-through theory is sound and the reduction in current taxes is a permanent saving, *utilities should be required to utilize that procedure.*" (Italics added.)

9. Internal Revenue Code of 1954, section 167*(l)*, as amended December 30, 1969; see *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 125.

method, referred to as 'normalization,'[10] was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation. If a utility used accelerated depreciation in determining its actual tax liability, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferrd tax reserve account. See *Amere Gas Utilities Co.*, 15 FPC 760." (*FPC* v. *Memphis Light, Gas & Water Div., supra*, 411 U.S. 458, 460 [36 L.Ed.2d 426, 430].) After the passage of these laws Pacific and General reversed their longstanding opposition to accelerated depreciation and began to take the larger deductions it authorized; they contended, however, that if the commission passed on to the ratepayers any of the savings thereby achieved, "degradation of service and possible financial collapse" would result and the utilities would "go bankrupt."[11]

In the wake of these developments a divided Public Utilities Commission decided that it "could not continue the existing method of *imputing* accelerated depreciation" to the utilities (*City and County of San Francisco* v. *Public Utilities Com.*, *supra*, 6 Cal.3d 119, 125; italics added) and therefore that "it would now be futile to consider' " other methods benefitting the ratepayer because normalization was the only available alternative. (*Id.*, at p. 126.) We annulled.

In a unanimous opinion we held that the commission had

10. Internal Revenue Code of 1954, section 167*(l)*(3)(G), as amended December 30, 1969. As we explained in *City and County of San Francisco* v. *Public Utilities Com., supra*, 6 Cal.3d 119, 128: "Although the majority opinion [of the commission] ignores this matter, the concurring opinion and the two dissenting opinions [of the commission] recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will 'provide a source of interest-free capital.' We do not know how much capital will be provided, but the dissenting commissioners estimate that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars."

11. The commission rejected these contentions abstaining from passing the tax benefits of accelerated depreciation on to the ratepayers only because of its doubts about its legal power to do so.

not regularly pursued its authority in failing "to consider lawful alternatives in calculation of federal income tax expense." (*Id.*, at p. 130.) Specifically, we ruled that the commission should consider alternatives, which, while taking into account "the imprudent management"[12] of the real party in interest, might serve as "a compromise striking a proper balance between the interests of the ratepayers and . . . [real party in interest] in the light of current federal income tax statutes." (*Ibid.*) The instant case arises from the commission's action on remand.[13]

Following our annullment of its decisions in *City and County of San Francisco* and *City of Los Angeles*, the commission held new hearings. In the case of Pacific we had annulled a final rate,[14] and the commission therefore held entirely new ratemaking proceedings, considering each aspect of revenue and expenses anew. General's case involved an additional factor; as we set forth in the margin, the commission considered appropriate ratemaking treatment of tax expenses for General in two separate proceedings, once in a limited rehearing of a

12. In the case from which we quote, the phrase referred exclusively to Pacific, but, as we have subsequently pointed out, it might apply equally to General: "Apparently all utilities in California except Pacific and General Telephone follow accelerated depreciation with flow through.... Pacific and General Telephone have apparently in the past used straight line depreciation." (*City of Los Angeles* v. *Public Utilities Commission* (1972) 7 Cal.3d 331, 338-339, fn. 2 [102 Cal. Rptr. 313, 497 P.2d 785]; cf. *Re General Telephone Co. of Cal.* (1974)—Cal.P.U.C.—Decision No. 83778,pp, 23, 39).)

13. Because we held that the commission's failure to consider lawful alternatives in tax treatment was error, and because we subsequently found that this and other errors could not be severed from the remainder of the rate, we annulled the entire Pacific rate. (*City of Los Angeles* v. *Public Utilities Commission* (1972) 7 Cal.3d 331 [102 Cal.Rptr. 313, 497 P.2d 785].) As noted below (fn. 15, *infra*) the commission, perceiving that the Pacific and General cases involved identical legal issues, reheard the General case. Thus, although strictly speaking, "remand" was involved only in the Pacific case, the commission reconsidered both cases, and we now have before us the results of that reconsideration.

14. See *City of Los Angeles* v. *Public Utilities Commission, supra*, 7 Cal.3d 331, 354-359.

rate case contemporaneous with the annulled Pacific decision,[15] and once in hearings held pursuant to a new rate increase request by General.[16] Because all three of these proceedings reached substantially identical treatments of the tax expenses in question by a substantially identical procedural route, we shall describe them as a single proceeding, noting divergences only when necessary.[17]

The commission focused most of its attention on a staff proposal somewhat awkwardly styled "pro forma normalization." Stated briefly, this proposal involves an accounting adjustment which takes account of the fact that the deferred tax reserve (an asset) is much lower at the start of the ratemaking period than it will be after the effects of accelerated depreciation accumulate.[18] The staff plan called for a reduction in the rate

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15. At the time we filed *City and County of San Francisco* v. *Public Utilities Commission, supra,* 6 Cal.3d 119, the commission had just granted General a rate increase based in part upon the same treatment of accelerated depreciation which we found unlawful in *City of Los Angeles* and *City of San Francisco.* (*Re General Telephone Co. of Cal.* (1971) 72 Cal. P.U.C. 652.) Recognizing that the same legal issue controlled both the Pacific and General rates, the commission in response to petitions by the Cities of Los Angeles and Long Beach granted rehearing. (*Re General Telephone Co. of Cal.* (1971) 72 Cal.P.U.C. 725; *Re General Telephone Co. of Cal.* (1972) 72 Cal. P.U.C. 795.) These orders continued in effect the rates promulgated before *City of Los Angeles* was filed, but made them subject to refund if the commission subsequently found them unjustified. (We consider *infra* at pp. 705-707 the propriety of the interim order and the rates established by it.)

16. *Re General Telephone Company of Cal.* (1975)—Cal. P.U.C.—(Decision No. 83779).

17. The commission's most elaborate and most complete response to the problem and to our order on annulment occurs in its decision in the Pacific case (Decision No. 83162). While considerable discussion is devoted to the topic in the limited rehearing of the General case (Decision No. 83778), the commission staff had at the time of hearing of that matter not yet fully developed its alternative proposals. The two General cases (Decisions Nos. 83778 and 83779) were filed after the Pacific proceeding and rely heavily on it; the Pacific decision (No. 83162) thus becomes the key commission response.

18. As we have noted, the crucial fact about this deferred tax reserve is that it is a misnomer; unlike other deferred reserves, this one represents not a putting-aside for expenses which will later be encountered, but a *permanent savings.* (See fn. 6, *ante,* and text thereto.) Moreover, the utility can earn interest on this reserve and, unless some adjustment is made, will earn a return from ratepayers on it.

base (on which return is calculated) to reflect what is, in effect, an additional source of revenue for the utilities.[19] The commission, however, rejected pro forma normalization on the grounds that it would violate the provisions of the Internal Revenue Code and of a Treasury Regulation interpreting it.[20]

With its attention thus concentrated on the primary staff proposal and Pacific's and General's vigorous objections to it, the commission gave only cursory consideration to another proposal, known as "annual adjustment."[21] The record indicates that the hearing examiner suggested to the parties that the feasibility of a system of yearly automatic rate adjustment be investigated. The staff witness accordingly prepared exhibits and testified at some length concerning this rate setting system.[22]

While technical in its application, the concept of an annual

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19. In order to effect this adjustment withuot running afoul of the new Internal Revenue Code restrictions, the staff proposed to hold the rate of return "even," but to decrease the *rate base.* Pro forma normalization accomplishes this result by substituting for the deferred tax reserve of the *historical* test year which the commission uses to set rates, a figure based on projections of *future* accumulations of this reserve.

20. While the commission's proceedings in the instant cases were pending the Treasury promulgated a series of regulations which in the commission's view, precluded pro forma normalization. (Treas. Reg. § 1-167 (*l*)-1(*h*)(6) (1974).) We here reiterate that in view of our disposition of these cases, we express no opinion regarding the validity of the regulation as an interpretation of section 167 of the Internal Revenue Code of 1954 (cf. *Arkansas-Oklahoma Gas Co.* v. *Commissioner of Int. Rev.* (8th Cir. 1953) 201 F.2d 98, 102; Mertens, The Law of Federal Income Taxation (rev. ed. 1974) § 3.21, p. 46), the constitutionality of the regulation as an infringement of the powers reserved to the states under the federal Constitution (U.S. Const., Amend. X), or the continued availability of pro forma normalization (cf. fn. 42, *infra*).

21. The commission devoted a scant ten lines to its discussion of annual adjustment in its original decision in the Pacific case (Decision No. 83162) and supplemented this consideration with but three additional sentences on denial of rehearing (Decision Nos. 83540). Mention of this opinion on denial of rehearing makes it appropriate to indicate at this point that the commission neither violated the statutes governing its procedures nor trespassed on its discretion in supplementing its opinion upon denial of rehearing. (Pub. Util. Code, §§ 1708, 1736.) Petitioners' contentions to the contrary are meritless.

22. At the request of Hearing Examiner Barnett the staff witnesses developed the requested information. Their testimony and cross-examination by various parties covers more than 50 pages of reporter's transcript. In addition they submitted some 20 supplemental pages of explanation in the form of exhibits.

adjustment is essentially simple: the rate established by the commission includes a formula which, when applied each year to figures in the utilities' accounts, produces appropriate adjustments in rates to keep them in step with the company's changing financial situation.[23] In the case of annual adjustment to reflect the growing deferred tax reserves, the *actual* amount of the reserve accumulatd by the utility would be compared with the amount used in the test year on the basis of which the commission set rates.[24] As the reserve grew, the formula would effect a corresponding reduction in the rate base to take account of this new source of investment capital.

The effect of annual adjustment in some respects resembles that which would occur if the commission each year conducted a new rate proceeding in which all factors except that of tax reserve held constant. In such a case the commission would look to the tax reserve as the sole relevant variable and reduce the rate base to compensate for tax reserve accumulations. As long as the commission's policy towards the tax reserve accumulations remained unchanged, however, such yearly proceedings would reduce themselves to substantially ministerial steps.[25] In similar circumstances the commission has concluded

23. For more than three years, subsidiaries of the Bell System providing telephone service in Illinois, New Jersey, and Canada have *sought* "automatic" adjustment clauses to enhance utility productivity and compensate for price and cost fluctuations (Kendrick, *Efficiency Incentives and Cost Factors in Public Utility Automatic Revenue Adjustment Clauses* (1975) 6 Bell J. Econ. 299, 304-309 [hereafter cited as Kendrick]).

24. In fact, the staff witness suggested two forms of annual adjustment. In one, known as January 1st adjustment, the commission would employ the estimates of tax reserves on the company's books at year end to make its adjustment; in the other form, the commission would wait until the following October, at which point the final figures would be in, before making the adjustment. The disadvantage of the October method flows from the nine-month lag in rate relief, a lag whose effect is cumulative; the advantage of the October clause is that it is based on final figures ascertainable after the company's books have been audited. We perceive no statutory or constitutional significance to flow from the difference between these two methods, and what we say below applies equally to both of them.

25. As in the case of "automatic" adjustment clauses for productivity and price fluctuations (Kendrick, *supra*, at pp. 306-309), the regulatory commission's primary function should be to gather empirical data periodically on changes on each utility's tax reserve accumulations and then apply relevant data to the adjustment formula.

that the promulgation and periodic application of an adjustment formula more effciently implements its policy.

The commission thus employs adjustment clauses when it encounters an item of expense or revenue which tends to vary abnormally in comparison to the utility's other financial data; fuel cost adjustment clauses, which the commission presently inserts in the tariffs of power companies, constitute a prominent current use of such clauses. The commission's staff experts testified that the rapidly accumulating tax reserves presented an anomalous factor in the telephone companies' financial profile similar to that posed by the fuel costs of the power companies.[26]

The commission accepted this analysis, explaining that: "One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base." (*Re Pacific Telephone* (1974)—Cal.P.U.C.— Decision No. 83162, slip opn. 63); accord, *Re General Telephone Company of California* (1974)—Cal.P.U.C.—(Decision No. 83778, slip opn., p. 24).)

In spite of the applicability of the usual justifications for annual adjustment clauses to the instant cases, however, the commission without consideration rejected its staff's recommendation that such clauses be made a part of the tariff in the event flow-through and pro forma normalization were re-

26. In the words of the staff witness who explained the mechanics of annual adjustment: "As I have testified and demonstrated both in an earlier phase of this proceeding and in the reopened proceeding of General Telephone Company . . . , the growth of the deferred tax reserve *far exceeds the normal growths of revenue, expenses, and rate bases, which tend to grow proportionately.* . . . The rates of most California utilities are set on the basis that revenues, expenses, and rate base will grow somewhat in *proportion* and these same utilities have no reserve as they are on flow through. For a normalization company like Pacific, the rate base *cannot grow as fast as it normally would* because the deferred tax reserve is displacing investment which would come from stock or bondholders for a straight line or flow through company." (Italics added.)

jected.[27] The commission explained its refusal to consider annual adjustment clauses in the following terms: "Nor will we consider further the automatic adjustment clause. This method was proposed with the understanding that the commission would consider it only if Pacific consented to its imposition; Pacific has not consented." (*Re Pacific Telephone and Telegraph Company* (1974) — Cal.P.U.C. — (Decision No. 81362, slip opn. p. 59).)

Elaborating on this somewhat cryptic statement[28] in its opinion on denial of rehearing, the commission indicated that its refusal to consider annual adjustment stemmed from its belief that "Any order which would have the effect of automatically reducing the rates of any utility without hearing and without the opportunity for hearing would be inconsistent with the Public Utilities Code unless the consent of the utility was first obtained. Our rejection of the automatic reduction method stems not from any undue consideration for Pacific but from a due regard for statutory limitations."[29] (*Re Pacific Telephone and Telegraph Company* (1974)—Cal.P.U.C.—(Decision No. 83540, slip opn. p. 10).) We must therefore examine the legal bases of the commission's refusal to entertain the system proffered by its staff.

27. The staff witness indicated that annual adjustment ranked just behind pro forma normalization as a desirable alternative to normalization, which was the plan proposed by the utilities.

28. Neither the real parties nor the commission has indicated the origin of the "understanding" to which the decision refers; any such understanding would in any case be irrelevant in light of our order on annulment to consider "alternative approaches" to the problem which accelerated depreciation posed for ratemakers. (*City and County of San Francisco, supra,* 6 Cal.3d 119, 130.) Parties may not by consent disregard directions of this court.

29. In so ruling the commission seemingly assumed that annual adjustment conformed to Internal Revenue Code of 1954 section 167, subdivision (*l*) (3) (F) and Treasury Regulation, section. 1-167(*l*). Since the instant cases, of course, do not squarely present the question of the congruence of annual adjustment and the Internal Revenue Code, we do not address the issue. We note in passing that in concept, annual adjustment closely approximates annual ratemaking, and the Internal Revenue Code does not, of course, forbid such a procedure. (See Treas. Reg. § 1-167(*l*)-1(h) (6) (ii).)

2. *The Public Utilities Commission failed regularly to pursue its authority in refusing to consider annual adjustment as an alternative rate setting system.*

The commission in these cases operated under a dual obligation to weigh and explain its actions in regard to the treatment of accelerated depreciation. First, it acted, as always under the statutory obligations of insuring that all utility rates are just and reasonable (Pub. Util. Code, § 451), that no utility raises its rates unless the commission finds the increase justified (Pb. Util. Code, § 454), and that its decision "contain[s], separately stated, findings of fact and conclusions of law . . . on all issues material to the order or decision" (Pub. Util. Code, § 1705).[30]

In addition to these continuing statutory duties, the commission in the instant case was also bound by our order in *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, in which we annulled a tariff for the commission's "failure to consider lawful alternatives in calculation of federal income tax expense" (*id.,* at p. 130), and in which we indicated that the commission should consider available alternatives. Thus the commission labored under a two-fold obligation thoroughly to deliberate upon methods of dealing with a problem it had perceived.

In spite of these statutory and judicial obligations, however, the commission failed to consider an annual adjustment provision, a plan suggested by its hearing examiner, testified to by its staff, concerning which full cross-examination had occurred, and which, on the face of the record, appeared capable of rela-

30. As Justice Traynor emphasized in the leading case construing the requirement of specific findings, a requirement added to the statute in 1961: "Even when the scope of review is limited, . . . findings on material issues enable the reviewing court to determine whether the commission has acted arbitrarily. . . . Findings on material issues can also serve to help the commission avoid careless or arbitrary action. . . . There is no assurance that an administrative agency has made a reasoned analysis if it need state only the ultimate finding . . . ." (*California Motor Transport Co.* v. *Public Utilities Com.* (1963) 59 Cal.2d 270, 274-275 [28 Cal.Rptr. 868, 379 P.2d 324].)

tively easy implementation. Speaking of a similar failure to consider relevant aspects of a decision, we recently explained "[t]he Commission may and should consider *sua sponte* every element of public interest affected by . . . [utility proposals] which it is called upon to approve. It should not be necessary for any private party to rouse the Commission to perform its duty. . . . Thus, we conclude that the Commission failed to give adequate consideration to the . . . issues . . . and that its decision must be annulled." (*Northern California Pawer Agency* v. *Public Util. Com.* (1971) 5 Cal.3d 370, 380 [96 Cal. Rptr. 18, 486 P.2d 1218]; accord, *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119; *City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.) If, as we have shown, unjustified failure to deliberate constitutes error, we must consider the grounds which the commission has proffered as justification of its refusal to consider annual adjustment.

In explaining its action the commission indicated that discussion of an annual adjustment clause would serve no purpose because Public Utilities Code section 728, which requires a "hearing" before the promulgation of rates placed beyond its power a tariff which would automatically reduce rates without such a hearing.[31]

(a) *The Public Utilities Code permits the use of annual adjustment clauses.*

(1a) Section 728 of the Public Utilities Code simply provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts";

31. The relevant sentence of Public Utilities Code section 728 reads as follows: "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

on its face, then, nothing in the statute is inconsistent with the use of an annual adjustment clause.

The commission and the utilities, however, impliedly assert that the terms "rates" and "hearing" in section 728 have extremely restrictive meanings which bar adjustment clauses. Their position depends upon the conception that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges. Neither contention withstands scrutiny.

In the first place, longstanding commission practice in other areas refutes its position in these cases. As testimony in the instant proceedings revealed, the commission has for a number of years included fuel adjustment clauses in the tariffs of power companies on the grounds that the variation in their fuel costs is disproportionate to the variation in their other costs.[32] Thus the commission itself has long recognized adjustment clauses do not exceed its authority.

(2) "Consistent administrative construction of a statute over many years, particularly when it originated with those charged with putting the statutory machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous. (*Federal Trade Com.* v. *Mandel Brothers* [1959] 359 U.S. 385, 391 . . .; *United States* v. *American Trucking Assns.* [1940] 310 U.S. 534, 549 . . .; *United States* v. *Leslie Salt Co.* [1956] 350 U.S. 383, 396 . . .; *Great Northern Ry. Co.* v. *United States* [1942] 315 U.S. 262, 275-276 . . .; *Norwegian Nitrogen Co.* v. *United States* [1933] 288 U.S. 294, 315 . . .; *Mazer* v. *Stein* [1954] 347 U.S. 201, 213 . . .; see 1 Davis, Administrative Law Treatise, § 5.06, p. 324.)" (*Di-Giorgio Fruit Corp.* v. *Dept. of Employment* (1961) 56 Cal.2d

32. *Re Southern California Edison Co. Ltd.* (1941) 43 C.R.C. 733; *Re Southern California Gas Co.* (1958) 56 Cal.P.U.C. 158; *Re California Electric Power Co.* (1958) 56 Cal.P.U.C. 221; see *Re Pacific Gas & Electric Company* AVTGVQ GV *Cal.P.U.C.* 724, 758-759; cf. *Riverside Cement Co.* v. *Public Util. Com.* (1950) 35 Cal.2d 328 [217 P.2d 403].

54, 61-62 [13 Cal.Rptr. 663, 362 P.2d 487].) **(1b)** Moreover, in the instant case no party presents any valid reason for holding this longstanding administrative interpretation unlawful.

In the face of this authority, the commission and the real parties in interest simply argue that the fuel adjustment clauses which it employs as a standard practice supply no precedent for the use of annual adjustment clauses for tax reserves. They urge that such clauses characteristically *raise* utilities' rates (as they have during the recent inflationary period) and therefore supply no authority for a clause which is expected to *reduce* rates.[33] In our opinion the objection is specious; the statutory language simply does not differentiate between the rate changes which increase rates and those which decrease rates.

Moreover, such consistent administrative practice accords with the conclusions of a sister court which, some 20 years ago, faced a question very similar to that which we now consider. In *Norfolk* v. *Virginia Electric etc. Co.* (1955) 197 Va. 505, 516-518 [90 S.E.2d 140], the Virginia Supreme Court addressed the contention that an annual adjustment clause could not be inserted in the tariff of a utility because the new rate would take effect without the 30-day notice to the public required by the relevant statute.

Rejecting this contention, the unanimous court wrote: "[T]he power of the Commission is not limited to the mere

33. During proceedings before the commission, Pacific raised the additional objection that power company fuel adjustment clauses supplied no precedent for the use of a tax reserve clause because the commission derived its power to use fuel clauses from Public Utilities Code section 454, not section 728. Section 454, however, merely exempts rate increases established pursuant to adjustment clauses from the new requirement that certain classes of utilities enclose with their regular billings all notices of rate increase applications. Only *common carriers* are exempted *additionally* from the requirement of a hearing before rate increases (Pub. Util. Code, § 454, subd. (b)). Thus section 454 establishes no exemption from setcion 728 for fuel clause increases; if, therefore, hearings are required before all rate changes under section 728, they are also required for fuel clause changes. As we have shown, however, such hearings are not requisite when they have occurred as to the general tariff including such adjustment clauses.

change of a particular rate that the public must pay for the service rendered by a public utility, but it has the power to change . . . any part of a filed schedule, rate, rule or regulation that in any manner affects the rates charged or to be charged. . . . '[R]ate schedules consist not merely of lists of rates in dollars and cents, but . . . they customarily include provisions that will in various ways affect the rates charged at the time of filing or to be charged thereafter.' [¶] The proposed escalator clause is nothing more or less than a fixed rule under which future rates to be charged the public are determined. It is simply an addition of a mathematical formula to the fixed schedules of the company. . . . [I]t is clear that notice is not required on each occasion there is a change in the ratepayers' bills, but that notice is required for every change in the filed schedules which are the underlying bases for the computation of those bills."

Finally, in addition to longstanding administrative interpretation and the judicial authority described above, the purpose behind the hearing requirement of section 728 demonstrates the permissibility of the annual adjustment scheme here at issue. The purpose of the hearing is to air the policy considerations behind various rate proposals and to establish controverted facts; as the commission's experience with fuel clauses has shown, a hearing serves no purpose when the only business at hand is the application of a mathematical formula to a figure definitively established by reference to the utilities' books. The legislative purpose behind section 728 is better served by a plenary consideration of the advantages and disadvantages of an annual adjustment clause than by a yearly charade attendant to its application.

(b) *The Constitution does not forbid the use of annual adjustment clauses.*

(3a) As noted, the commission and the real parties in interest additionally argue that because a tariff containing an automatic adjustment clause could result in a decreased rate

which would take effect without a prior hearing attendant to a full rate proceeding, the resulting rate decrease would constitute a taking without due process, in violation of the Fourteenth Amendment of the United States Constitution. As we explain, however, this argument ignores the elaborate safeguards attending both the establishment of the accounting procedures which the utilities must use to produce the relevant figures and the full hearing which would accompany the establishment of the tariff containing the adjustment clause. As we shall show, under the governing authorities, these safeguards render the use of annual adjustment clauses entirely constitutional.

(4) Before discussing the specific objections to the adjustment clause, we review the constitutional standards which the United States Supreme Court has set forth for such rate proceedings. The court has long made it clear that within the regulatory context due process is a flexible concept, permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

(5) Thus, in sustaining the actions of a federal regulatory agency against the complaint of a utility that commission procedures in setting rates had deprived it of a hearing, the court set forth the relevant due process criteria: "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." (*Power Comm'n* v. *Pipeline Co.* (1942) 315 U.S. 575,

586 [86 L.Ed. 1037, 1049-1050, 62 S.Ct. 736]; accord, *R. R. Comm'n* v. *Pacific Gas Co.* (1938) 302 U.S. 388 [82 L.Ed. 319, 58 S.Ct. 334]; *West Ohio Gas Co.* v. *Public Utilities Com'n.* [No. 1] (1935) 294 U.S. 63, 70 [79 L.Ed. 761, 768-769, 55 S.Ct. 316]; *Market Street R. Co.* v. *Comm'n* (1945) 324 U.S. 548, 562 [89 L.Ed. 1171, 1182, 65 S.Ct. 770]; see *Norwegian Nitrogen Co.* v. *United States* (1933) 288 U.S. 294, 317, 319 [77 L.Ed. 796, 808, 809, 53 S.Ct. 350].)

(3b) With these precepts in mind, we consider the utilities' contention that the use of an annual adjustment formula exceeds constitutional bounds because it fails to provide the utilities with a prior hearing before each annual adjustment of rates occurs. As we explain, however, contrary to the utilities' assertions, procedural safeguards mark every stage of the adoption of the annual adjustment formula.

As we have already shown, the commission must hold a full hearing before the promulgation of a general rate tariff. (Pub. Util. Code § 728.) At such a hearing, the company has the opportunity through testimony, briefs, exhibits, and oral argument to inspect and challenge any formula proposed. (Pub. Util. Code, § 1705; Cal. Admin. Code, tit. 20, §§ 52, 59-61, 64, 68-70, 75-76.) The utility may at that hearing raise its objections either to the general concept of an adjustment clause or to the particular one proposed. It can point to states of fact on which the formula might yield an unjust or undesirable result and suggest corrective modifications. Indeed Pacific, at whose hearing annual adjustment was most fully developed, in fact took advantage of most of the procedural rights just enumerated. Under the circumstances, the promulgation of an annual adjustment formula as part of a general utility tariff obviously comports with due process; it remains therefore only to consider if the periodic application of the formula to the figures in the utility's books entails any denial of due process.

The adjustment clause would operate upon figures which the utilities had placed in their account books in accordance

with the system of accounts as to which the companies had received another, prior hearing. (Pub. Util. Code, §§ 792, 794.)[34] The utility, of course, would have made the entries with the full knowledge that the commission would employ them in connection with the annual adjustment clause.[35] Having thus obtained the appropriate figures from the utilities' accounts (cf. Pub. Util. Code, § 791), the commission would proceed to apply them to the formula as to which the utility would have enjoyed ample opportunity to make its objections known at a full hearing. (Pub. Util. Code, § 728; Cal. Admin. Code, tit. 20, §§ 51-88.) The insertion of numbers derived[36] from an accounting system adopted at one hearing, into a formula approved at another hearing does not deny due process; the Fourteenth Amendment to the United States Constitution does not prohibit arithmetic.

Our holding accords with the authorities. Most closely in point is the decision of the Virginia Supreme Court, which faced, in addition to the statutory issues discussed above, a

34. Empowered by law to "establish a system of accounts to be kept by the public utilities subject to its jurisdiction" (Pub. Util. Code, § 792), the commission has, when appropriate, held hearings on the establishment of such uniform accounts. (See *In re Uniform System of Accounts* (1948) 48 Cal.P.U.C. 253; *First Supplemental Order* (1957) 55 Cal.P.U.C. 668; cf. Pub. Util. Code, § 793; 64 Cal.P.U.C. 27; 70 Cal. P.U.C. 470.) Having established such accounting systems, the commission may prescribe the manner in which the regulated utilities employ them, but only after granting the utilities an opportunity to be heard on this question. Public Utilities Code section 794 provides that: "[t]he commission may, *after notice, and hearing* if requested within 15 days after receipt of notice, prescribe by order the accounts in which particular outlays and receipts shall be entered, charged or credited." (Italics added.) The commission's decision after such a hearing is of course subject both to rehearing and to judicial review. (Pub. Util. Code, §§ 1731, 1756.)

35. Such figures might include both already incurred tax expenses and the utilities' own estimates of future tax expenses. The staff member testifying most extensively as to the annual adjustment method idicated that it might be desirable to confirm the figures for tax expenses with those reported to the utility's stockholders under the reports required by the federal Securities and Exchange Commission.

36. As in the case of fuel clauses, the commission may find it necessary to make minor adjustments in the raw figures derived from the utilities' books before applying them to the annual adjustment clause. In light of the protections attending the development and use of the clause, we perceive no constitutional significance to flow from this practice.

claim by ratepayers that a fuel adjustment clause would deprive them of due process because it did not afford them notice and hearing as to each of its applications; the court rejected the claim.[37] (*Norfolk* v. *Virginia Electric, etc. Co., supra,* 197 Va. 505.)

In so holding, the Virginia court spoke to the issue before us; after pointing to the widespread adoption of such clauses and their survival of legal challenges, it succinctly refuted the claim that their application constituted a denial of due process: "The City next contends that the escalator clause results in a denial of procedural due process of law to the consumers because there is no public notice and hearing on each occasion when the actual rate is increased. . . . In the instant case there was sufficient notice to the public that the Commission would hold a formal hearing on the application of the Company to determine whether it was just and reasonable to insert the escalator clause into its filed schedules. The City appeared and participated in the proceedings and after an investigation by the Commission and a full hearing, the Commission found as a fact that the proposed escalator clause was 'just and reasonable', a finding which the record does not warrant us in reversing. Consequently, the requirements of procedural due process have been fulfilled in this case. See, e.g., Railroad Commission of State of California v. acific Gas & Elec. Co. [1938] 302 U.S. 388 . . .; Ohio Bell Telephone Co. v. Public Utilities Comm. [1937] 301 U.S. 292 . . ." (*Norfolk* v. *Virginia Electric, etc. Co., supra,* 197 Va. 505, 516-518.)

Norfolk thus stands for the proposition that due process requires adequate hearings at the significant point of the adoption of the adjustment clause, rather than at the relatively unimportant occasions of its application. Measured by this

37. The court in considering the ratepayers' claims assumed that they stood entitled to due process in connection with any increase in their rates; the utilities in the instant cases can therefore derive little comfort from the circumstance that the customer rather than the utility raised the due process claim.

standard, the system of annual adjustments proposed by the hearing examiner and the commission staff would offend no tenet of due process.

This conclusion finds additional support in cases which have addressed the question whether due process requires that agencies afford regulated entities a hearing before acting on the basis of figures or data supplied to the agency by the utility itself. The question is relevant to the instant case, because the annual adjustment clause would operate upon figures entered by the utilities upon its own books. The utilities claim that due process entitles them to a hearing prior to the use of such figures; the authorities do not support this contention.

In a leading case a unanimous United States Supreme Court rejected the contentions of a California utility that the commission had denied it due process by using, at its rate base, the figure for which the utility had offered to sell itself to the city in which it was located. (*Market Street R. Co.* v. *Comm'n., supra,* 324 U.S. 548.) The railway argued that the use of this figure, which had found its way into evidence incidentally, and which the commission had not indicated it would use to fix the utility's value, denied it due process absent an opportunity to present argument concerning the accuracy and interpretation of the figure. The Supreme Court found the argument without merit; Justice Jackson, writing for the court, noted that the figure in question had been admitted into evidence without limitation as to use: "Doubtless the decision and the grounds of decision were unexpected. But surprise is not necessarily want of due process." (*Id.,* at p. 558 [89 L.Ed. at p. 1180].)

Nothing in the operation of the annual adjustment clause as here proposed even approaches the procedure which generated the utility's complaint in *Market Street Railway;* unlike the railway, the telephone companies would at all times know the use to which the commission intended to put the tax re-

serve figures and would have an ample opportunity to make known their views of such proposed use.[38] (See *American Toll Bridge Co.* v. *Railroad Com.* (1938) 12 Cal.2d 184, 203-204 [83 P.2d 1].)

As further demonstration of the annual adjustment clause's impregnability to constitutional attack, we briefly contrast its operation with regulatory procedures which have *failed* to survive judicial scrutiny under the due process clause. The utilities insist that these cases pose an insuperable constitutional barrier to the use of an annual adjustment clause; we shall show, however, that they are in fact entirely distinguishable. In *Ohio Bell Tel. Co.* v. *Comm'n., supra* 301 U.S. 292, the commission had, without informing the utility of its intention to do so, taken judicial notice of a general decline in the prices of property and then adjusted downward the values of particular utility properties, all without telling the utility of the method by which it arrived at its figures or permitting it to challenge them; the court held this procedure unconstitutional.

Without belaboring the obvious differences between the unconstitutional procedure in *Ohio Bell* and that proposed in the case of annual adjustment, we simply note that in the latter instance the operative asumptions of the commission would at all times be known to the parties. (Accord, *Moore-McCormack Lines, Inc.* v. *United States* (1969) 413 F.2d 568, 585 [188 Ct. Cl. 644].)

In striking down the procedure in *Ohio Bell* the court made reference to an earlier case upon which the utilities before us

38. In a case similar to *Market Street Railway,* an Emergency Court of Appeals rejected a claim by a manufacturer subject to the authority of the Office of Price Administration. The administrator, in fixing the price on regular building blocks sold by the manufacturer, had calculated the manufacturer's cost by subtracting from a figure previously supplied by the plaintiff for blocks with special features the sum claimed to be attributable to such special features. (*Schiefla* v. *Clark* (E.C.A. 1974) 163 F.2d 685.) The court held that the use of the plaintiff's own figures did not constitute a denial of due process even though the manufacturer had received no prior notice of the purpose for which the administrator might use the figures.

rely; *West Ohio Gas Co.* v. *Comm'n.* [No. 2], 294 U.S. 79 [79 L.Ed. 773, 55 S.Ct. 324], epitomized the defects also found in *Ohio Bell.* In *West Ohio* the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignoring available revenue and expense data from 1930 and 1931; the court held this procedure unconstitutional.

In examining the flaws in *West Ohio* one is struck by the contrast they present to the proposed annual adjustment clause in question, in spite of the utilities' assertion to the contrary. The defect in the *West Ohio* case lay in the commission's refusal to consider the latest available data as to costs and revenue; yet annual adjustment entails precisely the substitution of actual figures for guesses and estimates of tax expense and deferred reserves. Rather than taking a single year as the measure of tax reserves, the commission staff proposed to make period adjustments in the figures in the light of actual experience, prcisely the course approved by the court in *West Ohio.* The utilities, of course, complain that the commission would make such adjustments only in the tax deferral figures, and not in the other revenues and expenses of the company; but, as we have already shown, the distinctive treatment of tax expenses and reserves finds its warrant in the circumstance that under accelerated depreciation they will vary abnormally with respect to the other components of the utilities' finances. Simply to recognize this fact is not to deny due process.

Nor does due process require a hearing that serves no useful purpose. In the instant case the only relevant inquiry turns upon the figures that stand in specified places in the utilities' books. No facts are open to serious dispute, no witnesses' demeanor need be judged, no policy decisions on which public sentiment might prove useful are before the commission. Within such a context, the facts are those which Professor Davis terms "legislative," and as to which a hearing serves no function.[39] (1 Davis, Administrative Law Treatise (1958) pp. 429-437 (1970 Supp.) pp. 327-329; *Rivera* v. *Division of Industrial Welfare* (1968) 265 Cal.App.2d 576 [71 Cal.Rptr. 739].)

The crux of the utilities' objections to annual adjustment lies in the possibility that under certain circumstances the annual adjustment clause might yield a rate below their authorized return, or in extreme situations, they assert, on the border of confiscation. The crucial point which they fail to discern, however, is that *any rate may have such an effect, no matter how calculated.*

An entirely fixed and stable rate may, if expenses rose dramatically, yield insufficient revenues to guarantee the utility a reasonable return. Yet we have never viewed this possibility as a ground for constitutionally requiring expense escalation clauses; the appropriate remedy in such instances is an application for a rate increase (Pub. Util. Code, §§ 454, 455). Conversely, the fact that a tariff containing an annual adjustment clause keyed to the growth of a deferred tax reserve may, under imaginatively conceived circumstances, rduce the rate of return below that authorized does not render it unconstitutional.

The utilities' objections are therefore inapposite. The due process cases they cite are, as we have shown, concerned with procedural defects not here present. Nothing in the procedures suggested to the commission will deny the utilities full hearings both on the system of accounts which will yield the figures in question and on the formula to which the figures will be applied.

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39. Nothing we say, of course, would preclude the commission from permitting the utilities to submit written briefs at the time of the annual adjustment, if the commission thinks such a procedure useful. Under the circumstances, however, this practice is not constitutionally mandated. (Cf. 1 Davis, Administrative Law Treatise (1970 Supp.) p.332; *Dyke Water Co.* v. *Public Utilities Com.* (1961) 56 Cal.2d 105 [14 Cal. Rptr. 310, 363 P.2d 326], cert. den., 368 U.S. 939 [7 L.Ed.2d 338, 82 S.Ct. 380].)

(c) *The commission therefore erred in failing to consider annual adjustment.*

Because annual adjustment comports both with the governing statutes and the Constitution, the commission failed regularly to pursue its authority in failing to consider it.[40] (Pub. Util. Code, § 1757.) On remand the commission should proceed either to take further testimony on the system, or to consider its adoption on the basis of the testimony contained in the record of the instant cases.[41] It should in any case weigh its desirability and set forth the reasons for the decision it ultimately reaches.[42] (Pub. Util. Code, § 1705.)

3. *The commission did not otherwise err.*

In the decisions before us the commission ruled as to a number of points other than those already discussed; the petitioning cities complain of several of these rulings. We have carefully examined both the petitioners' contentions and the record before the commission and find no error calling for annulment

40. In its opinion on denial of rehearing in the Pacific case the commission set forth an alternative proposal which entailed its reception of periodic reports of the utilities' profits with an eye towards reopening proceedings should they exceed the authorized rate. (*Re Pacific Telephone and Telegraph Co.* 1974)—Cal.P.U.C.—(Decision No. 83540).) The commission subsequently adopted the same procedure for General. (*Re General Telephone Company* (1974)—Cal.P.U.C.—(Decision No. 83779, slip opn., pp. 29-31.)) While such continuing supervision appears to be in commendable accord with the commission's statutory duties (Pub. Util. Code, §§ 451, 701, 728), it fails to serve as an adequate substitute for the consideration of annual adjustment on two grounds. First, the holding out of the possibility of future action does not constitute a justification for failure to take present action. Second, the commission's procedure verges dangerously on shifting the burden for justification of rate increases from the utility, where Public Utilities Code section 454 places it, to the ratepayer. The commission's order on denial of rehearing therefore does not alter the outcome of the instant case.

41. Pacific, of course, has had a full hearing on the use of annual adjustment, and as to it the commission enjoys the election described. In the General proceedings, the commission, although under a duty to do so, did not consider annual adjustment, and General consequently stands entitled to a hearing before incorporation of the system into its rates.

42. In this connection we emphasize that nothing in the course of this opinion should be construed as binding the Public Utilities Commission either now or in the future to any *particular* method of rate-setting which it decides is not useful. For instance, because the size of the utility's reinvestment is affected by the rate of inflation in the entire economy, under certain severe conditions of deflation even a utility expanding its plant

other than that indicated above.[43] (Pub. Util. Code, § 1757.) We dwell further on only one point which, because it relates to commission procedure, may recur.

(6) The petitioning Cities of Los Angeles and Long Beach (in S.F. 23237) complain that the commission erred in failing to abrogate General's entire staff after we annulled Pacific's tariff in *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119. In order to show that the commission did not err, we briefly set forth the relevant chronology.

When we disapproved the commission's order in *City and County of San Francisco,* the commission had just filed a decision incorporating a rate increase for General Telephone, based in part on the same treatment of federal tax expenses which we held erroneous in the *Pacific* case. (*Re General Telephone Co. of Cal.,* 72 Cal.P.U.C. 652.) Upon learning of our decision in *City and County of San Francisco* the cities which had appeared before the commission in the proceeding leading to the

investment would not incur sufficient expense (because the replacements would cost substantially less than the old assets) to offset the lower depreciation attributable to "old" assets in their later years. Under *such* conditions a public regulatory commission might well adjust its rate-setting assumptions. (Cf. *Power Comm'n* v. *Hope Gas Co.,* 320 U.S. 591 [88 L.Ed. 333, 64 S.Ct. 281]; *Bluefield Co.* v. *Public Serv. Com.* (1923) 262 U.S. 679, 692-693 [67 L.Ed. 1176, 43 S.Ct. 675].) Thus, should conditions change, or should the commission in the *considered* exercise of its discretion (Pub. Util. Code, § 1705) conclude that a method which we hold it empowered to employ is not suitable, it may reject the method.

Conversely, should the commission on remand decide that a method which it has previously rejected on prudential grounds now appears feasible, it may adopt the method. Thus, if, upon reconsideration, the commission should conclude to implement pro forma normalization on a tentative basis, with rates held in a trust fund, subject to refund upon final determination of federal tax questions, nothing we say here should be construed to forbid such a course of action. Alternatively, the commission could choose to mitigate the "windfall" accruing to real parties in interest in consequence of their failure to elect accelerated depreciation prior to 1969, by setting more modest rates of return in recognition of the additional source of capital available to the utilities by virtue of the federal tax laws.

We rule only on the *availability* of a method of remedying a serious problem perceived by the commission, a method whose usefulness the commission tacitly conceded, but which it declined to consider, solely because it believed itself powerless to implement.

43. As noted above, we do not in so holding endorse or pass upon the legal merits of the commission's interpretation of the 1969 amendments to the Internal Revnue Code and the regulations interpreting them.

General decision, petitioned for a *rehearing* which the commission granted. (Decisions Nos. 79532 and 79367.) We subsequently annulled the entire rate based on the tax decision held erroneous in *Ciay and County of San Francisco. (City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.)

In granting rehearing the commission limited the issues to the question of tax expenses and promulgated the previous tariff as an *interim* rate subject to refund if the commission subsequently found it erroneous. After this rehearing (at which the commission did not consider annual adjustment), it effectively reaffirmed the interim rates as part of the permanent tariff.

From the previous discussion, it is clear that as a substantive matter the commission erred in failing to consider annual adjustment.[44] The petitioning cities also complain, however, that the commission erred in repromulgating the tariff under attack as an *interim* rate; by analogy to our action in *City of Los Angeles* they argue that the commission bore the duty to annul the *entire* rate. Because the rates suffered from the same failure to consider alternatives, they argue, both rates must have been annulled. In this analogy between our decision and the commission action, however, lurks a fatal flaw.

The key to the distinction between the two cases lies in the difference in the commission's power, on one hand, to *reopen* proceedings already final, and, on the other, to *rehear* a decision not yet final. In *City of Los Angeles* we annulled the tariff in question, in spite of the fact that the commission had *reopened* rate proceedings under Public Utilities Code section

44. Because the commission took the steps just outlined, we were not called upon to annul General's rate as we had that of Pacific in *City and County of San Francisco.* The governing law, however, was clear from that case, and the commission bore a corresponding similar duty to consider alternative methods of dealing with General's accumulating tax reserves. Annual adjustment was before it in the parallel proceedings after annulment in the Pacific case, which was filed before the decision on rehearing in the General case.

1708. That section, which we set forth in the margin,[45] permits the commission at any time to reopen proceedings even after a decision has become *final,* as the commission decision in *City of Los Angeles* would have been had we not annulled. (*City of Los Angeles* v. *Public Utilities Commission, supra,* 7 Cal.3d 331.)

In that case we explicitly based our annulment on the decision's finality: "It follows that, unless the rate order now before us is annulled, it will *become a lawful rate* and that all funds collected pursuant to it would belong to Pacific and not be subject to refund. [¶] In other words, we must annul the rate order now before us, because otherwise the rates therein, which are based in part on the annulled tax expense decision, will *become lawful rates* for the future and will preclude refunds." (*Id.*, p. 338; italics added.)

In the General case, on the other hand, the time for *rehearing* had not expired and the rate had not become final and lawful. The difference in effect stems from the difference between Public Utilities Code section 1736,[46] which provides for an order on *rehearing,* and section 1708 which provides for *reopening.* The former procedure, which must take place within the time limits specified in section 1731, and only in response to parties' requests, contrasts with the latter, which is merely a general authority for the commission to reconsider some-

45. "The commission may at any time, upon notice to the . . . parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering, or amending a prior order or rdecision shall, when served upon the . . . parties, have the same effect as an original order or decision." (Pub. Util. Code, § 1708.)

46. Section 1736 reads in its entirety as follows: "If, after such rehearing and a consideration of all the facts, including those arising since the making of the order or decision, the commission is of the opinion that the original order or decision or any part thereof is in any respect unjust or unwarranted, or should be changed, the commission may abogate, change, or modify it. The order or decision abrogating, changing, or modifying the original order or decision shall have the same force and effect as an original order or decision, but shall not affect any right or the enforcement of any right arising from or by virtue of the original order or decision unless so ordered by the commission."

thing upon which it has previously ruled. Rehearing, unlike reopening, prevents an order previously made from becoming final. (See *Sale* v. *Railroad Commission* (1940) 15 Cal.2d 612, 616 [104 P.2d 38].) Because the commission *reheard* the General case, its order did not become final, and it could promulgate an interim rate subject to refu .. The commission's procedure in Decision 83778 was therefore lawful although its substantive result must be annulled for failure to consider annual adjustment.

4. *Order.*

Because the commission has failed regularly to pursue its authority, the rates here under review may not stand in their entirety. (Pub. Util. Code, § 1757.) Yet, because we have found error only in respect to the treatment of tax expenses, we need to annul only the portion of the rate based on such error. Unlike the situation facing us in *City of Los Angeles* v. *Public Utilities Commission, supra,* 7. Cal.3d 331, in which we noted that "[n]o basis appears to sever these matters from the increase of rates ordered by the commission, and it is not claimed that severance is possible" (*id.* at pp. 353-354), the commission in the instant case has gone to some lengths to "set out the dollar effect of the adjustment so that if . . . [it is] found wrong . . . the correct adjustment can readily be made." (*Re Pacific Telephone and Telegraph* (1974)—Cal. P.U.C.—(Decision No. 83162, slip opn. p. 64).)

Not only such passages but also the commission's actions in these cases demonstrate the severability of the tax related aspects of the rates before us. Thus upon rehearing in the General case, the commission discovered that California taxes, unlike their federal counterparts, were amenable to flow-through treatment and ordered appropriate refunds, thereby demonstrating the practicability of partial annulment. (*Re General Telephone of California* (1974)—Cal.P.U.C.—(Decision No. 83778, slip opn. pp. 48-49).)

In order, therefore, not to interfere with those portions of the tariff in which we find no reversible error, we affirm the commission's order except insofar as it depends upon the erroneous treatment of tax expenses set forth above; as to that portion of the rate we annul. The commission, on remand of this matter for further proceedings consistent with this opinion, shall expeditiously determine what position is will adopt with respect to the tax expense issue. (See *City and County of San Francisco* v. *Public Utilities Com., supra,* 6 Cal.3d 119, 130-131.) Having ascertained this position, be it annual adjustment or some other alternative, including the possibility of a commensurate adjustment in the rate of return, the commission shall provide for refunds, if appropriate, to the ratepayers of the difference between such a rate and the tariff reviewed herein.

Wright, C. J., McComb, J., Mosk, J., Clark, J., Richardson, J., and Taylor, J.,* concurred.

APPENDIX B

ANSWER OF CITY OF LOS ANGELES ET AL IN S.F. NO. 23743 AND S.F. NO. 23746 PP. 2-13

I.

PRELIMINARY STATEMENT

The Petitions of General and Pacific ask this Court to review the intrastate ratemaking treatment of accelerated depreciation and investment tax credit once again. This issue has been before the Commission and the California Supreme Court since 1970. On three separate occasions the California Supreme Court has unanimously annulled the Commission ratemaking treatment of these taxes.[1] In these cases, the Cities individually or in concert were petitioners seeking to overturn the Commission's adoption of the telephone companies' normalization method of ratemaking. The Cities have at all times asserted that a flow-through method of ratemaking is required.[2] This Court, in the three aforementioned unanimous decisions, rejected the Commission normalization orders and indicated that some compromise or alternative method would be a satisfactory solution for ratemaking purposes.

The present case arises out of a slightly different set of circumstances. The Commission for the first time has adopted a compromise between the telephone companies' normalization method and flow-through. Pacific and General challenge the Commission order and persist in their efforts to compel the commission to adopt the telephone companies' interpretation of normalization ratemaking as a matter of law.

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1. *City and County of San Francisco* v. *Public Utilities Commission,* (1971) 6 Cal.3d 119; *City of Los Angeles* v. *Public Utilities Commission,* (1972) 7 Cal.3d 331; *ity of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal.3d 680.

2. The flow-through and normalization methods are described in detail in *City and County of San Francisco* v. *Public Utilities Commission* (*supra*) and *City of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal. 3d 680.

The Cities believe that flow-through is the appropriate ratemaking treatment. Moreover, we believe the alternative adopted by the Commission in Decision No. 87838, although a compromise, fails to account for the imprudence of the telephone companies and therefore is not in the best interest of the ratepayers. Notwithstanding the disagreement with the Commission order, the Cities are not challenging Decision 87838. In this Answer we defend the Commission's decision as a good faith compromise consistent with the prior decisions of this Court.

The following reasons indicate the basis for our decision not to appeal:

1. The Con.mission did in fact adopt a compromise ratemaking method.
2. Although the position adopted by the Commission culminates in a significant windfall and financial advantage to the telephone companies, nevertheless the Cities believe that it was a good faith compromise consistent with the Court's directive to seek a reasonable alternative.
3. The Cities continue to believe that flow-through is the best ratemaking treatment or, in the alternative, that a better compromise can be achieved. However, we feel that in succeeding rate cases the Commission will have the opportunity to revise the ratemaking treatment ordered in Decision 87838 and at that time adopt the method advanced by the cities. The Court had made it clear that the commission is not and should not be bound to any *particular* method of ratemaking.[3] The Cities are encouraged by the Commission's recognition in Decision 88215 that flow-through may well be the proper methodology and subsequently could be adopted:

3. *City of Los Angeles* v. *Public Utilities Commission*, (1975) 15 Cal.3d 680 at 704, Footnote 42.

"We should also point out that if Pacific's and General's request result in a loss of eligibility it will be necessary for the Commission to consider setting the rates of Pacific and General on a flow-through basis." (*Pacific Telephone*, —— CPUC ——, Decision 88215, December 6, 1977 at p. 3 attached as Appendix A to this answer.)

4. We are in accord with Pacific's statement that "[t]his matter should be brought to a conclusion." (Petition, S.F. No. 23746 at Page 72.) Rates have been collected, subject to refund, since 1971 and the Cities believe that the refunds and reductions ordered by the Commission should be made forthwith. The Commission's good faith compromise, although inadequate by our standards, should be accepted and further revisions in rates can be made in subsequent cases.

The aforementioned reasons formed the basis for the Cities decision not to appeal the Commission's tax ratemaking treatment notwithstanding our belief that it is unfair to the consumers.

The remainder of this Answer will address the reasons for which this Court should deny the Petitions for Writ of Review. The subsequent sections will only answer the specific contentions raised in the Pacific Petition since for the most part the General petition is repetitious. However, in the area of managerial imprudence this answer will directly address the General Petition.

II

PACIFIC TELEPHONE HAS IMPROPERLY FRAMED THE RELEVANT ISSUES.

At the very outset of its points and authorities, on Page 11, Pacific declares in bold type that "[t]he federal tax questions are the central issues in this case." Moreover, the petition

closes with the statement that "[t]he intent of Congress and reqirements of Federal law should be observed and the decision should be annulled." (Pacific's Petition, S.F. No. 23746, at Page 72.) We disagree that these are the primary issues. Decision 87838 is unequivocally an intrastate ratemaking case. This is not a federal tax law case. The sole issue involved is whether or not the Commission adopted a ratemaking alternative consistent with the remand instructions of this Court. Decision 87838 must be analyzed from this perspective. It is our position that based upon specific holdings of this Court in prior cases (see Footnote 1, Page 2 of this Answer), that federal tax eligibility does not control ratemaking of the Commission. Therefore, Decision 87838 must be upheld irrespective of the federal tax law consequences.

III

THE PUBLIC UTILITIES COMMISSION IN DECISION 87838 ADOPTED A COMPROMISE RATEMAKING TREATMENT CONSISTENT WITH THE COURT'S REMAND INSTRUCTIONS AND CONSISTENT WITH RATEMAKING CRITERIA.

In the *City and County of San Francisco* v. *Public Utilities Commission,* (1971) 6 Cal.3d 119, and again in the *City of Los Angeles* v. *Public Utilities Commission,* (1975) 15 Cal.3d 680, this Court urged the Commission "to consider lawful alternatives in the calculation of federal income tax expense and to strike a compromise between the normalization method supported by the telephone companies and the flow-through method urged by the Cities." (*City of Los Angeles* v. *Public Utlities Commission, supra,* at Page 689.) This Court made it clear that flow-through was a lawful alternative despite the possible loss of tax eligibility and that the adoption of flow-through by the Commission would not deprive Pacific of due process. (*City and County of San Francisco, supra,* at Pages 127-131.) This Court's recognition that a method more favorable to Pacific would be equally acceptable is evident in the following quote:

> "Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." *City and County of San Francisco,* supra, at Page 131.

The Commission, in Decision 87838, adopted an alternative method of ratemaking as directed by this court. However, the Commission first found flow-through the best and most reasonable ratemaking treatment (Findings 1 and 2, Decision 87838 at Page 47.) Then it adopted normalization after safeguards were incorporated into the calculations to preclude Pacific and General from experiencing windfall profits. (Findings 3 and 4, Decision 87838 at Page 48.) The Commission recognized that the growth in the normalization reserve for both accelerated depreciation and investment tax credit was abnormal. (Finding 5, Decision 87838 at Page 49.) Failure to recognize such growth yields excessive rates above and beyond those consistent with normalization and rateable flow-through. For this reason the Commission took the following two steps:

1. With regard to accelerated depreciation it adopted the average annual adjustment method. Under this theory the Commission looks to the future taxes and the future growth in the normalization reserve.
2. With regard to the investment tax credit the Commission adopted the annual adjustment method discussed at length by the court in the Los Angeles Case (*City of Los Angeles, supra,.*)

These ratemaking methods achieve normalization accounting and concomittantly prevent windfall profits to the telephone companies. These methods also produce a slightly lower revenue requirement than the telephone companies' normalization method which was previously adopted by the Commission.

Consequently, the result is only a minor compromise between flow-through and normalization. This becomes evident once the impact upon the prospective reductions is contrasted with the amount of refunds which would result from the adoption of the full flow-method. If the Commission followed the recommendation of the Cities, a $261,000,000 rate reduction would have been required. (See calculation, Appendix B.) If the Commission had adopted the telephone companies normalization mthod, a rate reduction would not have been required. With the compromise ordered by the Commission, the total rate reductions mandated for Pacific was only $60,494,000. (Decision 87838 at Page 32.) This comparison clearly demonstrates the nature of the Commission order and cogently illustrates that the interest of the ratepayers suffered.

Assuming *arguendo* that normalization and rateable flow-through are reasonable means of ratemaking (an assumption with which the Cities totally disagree), then the average annual adjustment method and the annual adjustment method are necessary components of ratemaking. Rates would also be set on a test period basis. Moreover, the goal is not to determine actual expenses for that test period but to predict as reasonably as possible what will take place in the near future. The process is well described by the court in the following statement:

> "The test period is chosen with the objective that it present nearly as possible the operating conditions of the utility which are known or are expected to obtain during the future months or years for which the Commission purposes to fix rates. The test periods results are adjusted to allow for the effect of various known or reasonably anticipated changes in gross revenues, expenses, or other conditions, which did not obtain throughout the test period but which are reasonably expected to prevail during the future period for which rates are to be fixed, so that the test period results of operations as determined by the Commission will be as nearly represented of the future conditions as possible." (*Pacifc Telephone* v. *The Public Utilities Commission*, (1965) 62 Cal.2d 634 at 645.)

The extraordinary growth in both the normalization reserve and the investment tax credit, respectively, compelled the Commission to adopt its ratemaking methods for income tax treatment.

The methods (Average Annual Adjustment and Annual Adjustment) are consistent with the Commission's ratemaking treatment in other cases. With respect to state income taxes, the Commission adopted a projected three year average flow-through for accelerated depreciation as a result of the extraordinary growth in tax savings. (*Pacific Telephone*, —— CPUC ——, Decision Number 83162, July 23, 1974, at Page 74.) Moreover, this ratemaking method has gone uncontested by Pacific. In a Southern California Gas case, the Commission recognized the test year investment credit was extraordinarily high because of a gas storage project. Investment tax credit was therefore calculated on a five year average for the years 1971 through 1975 instead of merely adopting the 1972 test year figure. (*Southern California Cas Company* (1972) 74 CPUC 30, 49.) The aforementioned examples clearly illustrate that the Commission has adopted a ratemaking treatment consistent with the Court's directions and consistent with its own past regulatory treatment of similar issues.

IV

THE COMMISSION'S ORDER SHOULD BE SUSTAINED WITHOUT REGARD TO INCOME TAX ELIGIBILITY.

In succeeding sections we will demonstrate that the Commission's order will not cause Pacific or General to lose eligibility for tax savings available with accelerated depreciation and investment tax credit. The normalization method in addition will provide Pacific a massive windfall at the expense of the ratepayers in the form of reimbursement for nonexistent

taxes. Assuming *arguendo*, that Pacific and General will lose eligibility as a result of their efforts to gain a negative ruling from the Internal Revenue Service, this does not provide justification for overturning the Commission's order.

The court in the *San Francisco* case *(supra)* made it clear that flow-through was a reasonable ratemaking treatment in light of the imprudence of Pacific and General despite the possibility that the telephone companies could no longer use accelerated depreciation. (*City and County of San Francisco, supra,* at Page 129.) Hence, as a matter of law, this Court held that full flow-through is a viable legal alternative. This Court went on to state that a less harsh alternative would therefore be equally free from due process objection. (*City and County of San Francisco, supra,* at Page 130.) The ratemaking method adopted by the Commission will provide Pacific with over $200,000,000 more a year in revenues than imputed flow-through. Even with a loss of eligibility, this windfall is to the advantage of Pacific vis-a-vis flow-through. Neither state nor federal law prohibits the Commission from adopting such a ratemaking method and the Petitioners have failed to present any authority to the contrary.

The Commission provided this generous ratemaking alternative based upon its belief that such an alternative would preserve eligibility. If the Commission was wrong, income tax ineligibility would only provide a basis to revert back to flow-through. The Commission found the telephone companies to be imprudent and that flow-through was the proper ratemaking treatment. (Findings 1 and 2, Decision 87838, at Page 47.) In Decision Number 88215, the Commission expressly recognized that if Pacific loses eligibility, it would be necessary to consider setting rates on a flow-through basis. (See Decision 88215, Appendix A at Page 3.) If the Commission did make any legal error with regard to tax liability, this error resulted only in a massive windfall for the telephone companies and it not a basis for overturning Decision 87838.

June 22, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank K. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the State of California
State Building
350 McAllister Street
San Francisco, CA 94102

Re. S.F. No. 23746 (The Pacific Telephone & Telegraph Company v. Public Utilities Commission of the State of California) and S.F. No. 23745 (Toward Utility Rate Normalization v. Public Utilities Commission of the State of California)

Dear Chief Justice and Associate Justices:

The Commission has been served with a copy of a letter to the Court in this proceeding signed by counsel for petitioner, The Pacific Telephone Company (Pacific), and dated June 9, 1978. By this letter Pacific forwarded a copy of a recent letter from an employee of the Internal Revenue Service (I.R.S.) responding to a request by Pacific for a ruling supporting Pacific's position before this Court in this proceeding.

Ordinarily the Commission would not feel compelled to respond to such a letter; the Commission, of course, has no objection to Pacific's providing the Court with the I.R.S. letter. However, in this instance, Pacific was unable to resist the temptation to use this subsequent event as an opportunity to reargue its case. Moreover, in doing so, Pacific has misquoted the Commission, misstated the prime issue of these proceedings and persisted in a position as to the effect of an I.R.S. letter

on its eligibility for use of accelerated depreciation which is clearly contrary to law. Such contentions cannot go unanswered.

First, on page one of its letter, Pacific uses a phrase, ". . . horrendous consequences," places it in quotation marks and refers to certain pages of Decision No. 87838. The obvious conclusion is that Pacific is quoting the decision. However, this is incorrect; that phrase is not contained anywhere in the decision. The decision uses the word "horrendous" only once and that on page 10 where it states, after discussing the probable consequence of imputing flow-through for ratemaking purposes, "[t]his horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator."

Pacific's attempt to mislead the Court by misquoting the Commission's decision should be rejected.

Second, Pacific misstates the issue of these proceedings, as being " . . . whether the ratemaking methods adopted by the California Public Utilities Commission in Decision No. 87838 are consistent with the eligibility requirements of Federal law. . . ." Both Pacific and Toward Utility Rate Normalization (T.U.R.N.) posed many more issues than that in their petitions. Moreover, as the Commission pointed out in its answer, the prime issue is actually that of the lawfulness of the Commission's decision as an exercise of its mandated authority under the California Constitution and the Public Utilities Code.

Finally, and most importantly, Pacific would have this Court believe that, as a consequence of the I.R.S. letter, it has lost its eligibility to use accelerated depreciation. This is simply wrong. The opinion stated in the letter is made on the staff level and is not even binding on the I.R.S. It is not an assessment of tax liability. If this Court affirms Decision No. 87838 and the I.R.S. makes an assessment of tax liability adverse to

Pacific, such an assessment is appealable, administratively within the I.R.S., as well as through the U.S. Tax Court or the Federal District Court. This is a long road upon which Pacific may not have to travel but which the law very clearly has made available to any taxpayer.

Pacific chooses to pretend that such opportunities do not exist because such a posture suits its tactics before this Court and its use of its pleadings in these proceedings as news releases to the media. However, that pretense should not be allowed to obscure the fact that Pacific's eligibility or loss thereof will not be decided in the daily press nor by a letter from a staff member of the I.R.S. but, eventually, by the Court.

As to the I.R.S. letter itself, the Commission observes that the author thereof provides no basis for his conclusion that the AAA method is inconsistent with sections 1.167(l)-1(h)(1)(i), (iii) and 1.167 (l)-1(h) (2)(i) of the regulations and, furthermore, appears totally oblivious to the body of law which has explained that the use of accelearted depreciation along with the normalization of accounting results in a tax saving and not in a tax deferral (see page 17 of the I.R.S. letter). This Court, however, in *City of Los Angeles* v. *Public Util. Comm.* (1975) 15 C.3d 680, 686, 687, has recognized the true nature of this tax saving and cites therein the federal cases and other authorities which agree.

Given such demonstrated ignorance of the law, it is no wonder that the author of the I.R.S. letter was able to provide Pacific with the result it requested. As this Court already knows, Pacific's position to the I.R.S. was that Decision No. 87838, if allowed to become final, would result in loss of eligibility for use of accelerated depreciation (see page 6 of Pacific's letter to the I.R.S. attached to the answer filed jointly by the Cities of Los Angeles, San Diego, and the City and County of San Francisco). Faced with such an argument from the taxpayer, any other conclusion by the I.R.S. would have been surprising indeed.

Because the subject letter from the I.R.S. adds nothing to the issue of the lawfulness of Decision No. 87838, the Commission respectfully repeats its conclusion that the petitions for Writs of Review in these proceedings should be denied.

Very truly yours,

JANICE E. KERR
General Counsel

/s/ By WALTER H. KESSENICK
Principal Counsel

cc: All parties to S.F. No. 23746

WHK: gg

June 26, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank W. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the
State of California
State Building
350 McAllister Street
San Francisco, California 94102

RE: S.F. No. 23746, Pacific Telephone v. PUC—Reply to letter of June 9, 1978 of Pacific Telephone

Dear Chief Justice and Associate Justices:

On June 9, 1978, Pacific Telephone mailed the Court a three-page letter and attached an 18-page letter to Pacific from Geoffrey J. Taylor of the IRS, Engineering and Valuation Branch. In its letter at page 1, Pacific took the position that its Petition to the Court presented the question of eligibility for tax benefits. It intimated that Mr. Taylor's letter deprived Pacific of such tax benefits.

It is the position of the City and County of San Francisco, and Cities of Los Angeles and San Diego (Cities) that tax eligibility is not a relevant issue before the Court, and furthermore that Mr. Taylor's letter to Pacific is in no way dispositive of the tax issue.

In the Cities' Answer, we have argued that the federal tax issues are not the primary issues of this case, and the sole issue before the Court is whether or not the Commission adopted a rate-making alternative consistent with the remand instruction of the Court in *City of Los Angeles v. Public Utilities Commission*, 15 C.3d 680 (1975). It is our position that the

Commission's decision should be sustained without regard to income tax eligibility. This argument was presented to the Court at pages 6-7 and 12-13 of the Cities' Answer.

This position is based on *City and County of San Francisco* v. *Public Utilities Commission,* 6 C.3d 119, 129-130 (1971) where the Court held that "even assuming the absence of the option" to use accelerated depreciation, flow-through was a lawful alternative. The Commission, consistent with the Court's remand instruction, has selected as a compromise, a ratemaking alternative far more favorable to the utility than flow-through. (Cities' Answer, pages 9-10.) Under these circumstances, tax eligibility is not a relevant issue in determining if the Commission decision is consistent with the Court's remand.

Mr. Taylor's letter to Pacific is in no way dispositive of the tax eligibility issue. The letter itself was in response to Pacific's request to be declared ineligible. Pacific's position to Mr. Taylor was:

> "It believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements." (Letter of Pacific to IRS, dated September 29, 1977, Cities' Answer, Appendix D.)

Under these circumstances, it was fully expected that an IRS employee, such as Mr. Taylor of the Engineering and Valuation Branch, would agree with Pacific.

Mr. Taylor's letter, although lengthy, provides no analysis of the eligibility issue. For the most part, it is merely a lengthy recitation of Pacific's position. Taylor provides no justification for his conclusions. No case law is ever cited, and no analysis of the issue is even attempted.

If the Court affirms the Commission's order, Pacific will have an opportunity to challenge any tax assessments via various stages of internal review at the IRS, and via appeal to the Federal Courts. Arguments for eligibility which were not presented to or discussed by Mr. Taylor appear at pages 14-17 and Appendix C of the Cities' Answer. The Federal Courts, not Mr. Taylor, can determine Pacific's tax eligibility. If Pacific continues to seek ineligibility, there will not be an analysis of this issue.

Pacific has intentionally sought to be declared ineligible for accelerated depreciation. This is a calculated tactic, as Pacific has no other argument against the PUC order. Pacific's tactic is merely another example of "obstinacy" and "imprudent management." *City and County of San Francisco* v. *Public Utilities Commission, supra,* at 128, 129.

The Commission decision is harsh on ratepayers and rewards Pacific. (Cities' Answer, pages 9-10.) This further imprudence only provides grounds for the use of full flow-through. (Cities' Answer, pages 4-5.) Pacific's voluntary request for ineligibility does not improve its legal or equitable right to excessive rates based on phantom taxes.

Respectfully submitted,

City and County of San Francisco

George Agnost, City Attorney
Leonard L. Snaider, Dep. City Atty.
City of Los Angeles
Burt Pines, City Attorney
Thomas C. Bonaventura, Asst. City Atty.
Ed Perez, Deputy City Attorney
City of San Diego
John Witt, City Attorney
William S. Shaffran, Dep. City Atty.

/s/ By Leonard L. Snaider

LLS:mg

cc: All parties to S.F. No. 23746

July 11, 1978

Honorable Rose E. Bird, Chief Justice
Honorable Mathew O. Tobriner, Associate Justice
Honorable Stanley Mosk, Associate Justice
Honorable William P. Clark, Jr., Associate Justice
Honorable Frank K. Richardson, Associate Justice
Honorable Wiley W. Manuel, Associate Justice
Honorable Frank C. Newman, Associate Justice

The Supreme Court of the
State of California
State Building
350 McAllister Street
San Francisco, California 94102

Re: S.F. No. 23746, Pacific Telephone v. PUC—Reply to letter of July 5, 1978 of Pacific Telephone

Dear Chief Justice and Associate Justices:

In a filing of July 5, 1978, Pacific Telephone provided the Court a decision of the Maine Supreme Court, *New England Telephone and Telegraph Co.* v. *Public Utilities Commission,* and argued at page 3 of its letter, "The decision supports our Petition." It is the position of the City and County of San Francisco and the Cities of Los Angeles and San Diego (Cities) that the decision provided by Pacific reinforces the Cities' contention that this case presents issues of intrastate ratemaking, and should and must be decided consistent with the principles of California law and the decisions of the California Supreme Court.

The case before the Court does not involve an interpretation of federal tax law. The Maine Supreme Court overturned the ratemaking treatment adopted by the Maine Public Service Commission. The Maine decision did not turn on a definitive interpretation of federal tax law.

"We need not reach this substantive issue at this time, because we decide this case upon state law concerning the power of the Commission. We hold that the Commission's actions with respect to the accelerated depreciation issue constitute an abuse of its power and discretion in the rate-making process." (Slip opinion at p. 21.)

In the instant case, the California Commission has acted consistent with the criteria of this Court in the *City of San Francisco* v. *PUC,* 6 C.3d 119 (1971) and the remand in the *City of Los Angeles* v. *PUC,* 15 C.3d 680 (1975). This argument was developed in full at pages 7-11 of Cities' Answer.

The Maine decision only reinforces our interpretation of the issues raised in this case, and leads to the inevitable conclusion that the case must be decided "upon state law."

Respectfully submitted,

GEORGE AGNOST, City Attorney
LEONARD L. SNAIDER, Dep. City Atty.

CITY OF LOS ANGELES
BURT PINES, City Attorney
THOMAS C. BONAVENTURA, Asst. City Atty.
ED PEREZ, Deputy City Attorney

CITY OF SAN DIEGO
JOHN WITT, City Attorney
WILLIAM S. SHAFFRAN, Dep. City Atty.

/s/ By LEONARD L. SNAIDER

LLS:mg

cc: All parties to S.F. No. 23746

APPENDIX C

HR 6659—*A BILL*

To confirm the purpose of the accelerated depreciation provisions of the Internal Revenue Code, and to avoid loss to the Federal revenues in the case of regulated taxpayers through the application of these provisions contrary to the intent of Congress.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That it was the intent of the Congress in providing the depreciation methods referred to in section 167(b)(2), (3) and (4) of the Internal Revenue Code to increase available working capital and assist the modernization and expansion of industrial capacity for all segments of the American economy, both regulated and non-regulated, and in order to limit the loss of Federal revenues to the accomplishment of these purposes, no agency, instrumentality, commission or other similar body with authority to establish or approve the rates of any taxpayer shall, without the consent of such taxpayer—

(a) specify, or prohibit a change of, the method of rate of depreciation, allowable under the Internal Revenue Code, to be used by such taxpayer in computing the amount of its Federal income tax;

(b) determine such taxpayer's expense for Federal income taxes paid, or to be paid, for any period in establishing such taxpayer's cost of service (either to determine its overall rate of return or to reflect operating results in its books of account)—

(1) by using, or considering the availability of, any method or rate of depreciation allowable under the Internal Revenue Code other than that used, or proposed to be used, by such taxpayer in computing its Federal income tax for such period,

or

(2) in the case of any taxpayer which uses, or pro-

poses to use, one of the methods or rates referred to in section 167(b)(2), (3) and (4), by excluding from such tax expense the amount of any reduction in Federal income tax payable for such period attributable to the allowance of such method or rate;

(c) accomplish a result similar to those proscribed by paragraph (a) or (b) by any other treatment, device, or procedure.

SEC. 2—Effective Date. The provisions of this bill shall apply on or after [the date of introduction of this bill].

(Page V Table of Authorities Cited Pacific Telephone Petition For Writ of Review S.F. No. 23746)

TABLE OF AUTHORITIES CITED v

Pages

Constitutions, Codes, Regulations and Statutes

APPENDIX D

Appendix

THE PRESENT STATUS OF PACIFIC'S FEDERAL INCOME TAX LIABILITY

Pacific has claimed accelerated depreciation on its tax returns since 1970. The resulting tax deferrals have been invested in plant and equipment. The amounts are substantial:[1]

	1970	$ 6,917,000
	1971	38,029,000
	1972	56,090,000
	1973	71,502,000
	1974	91,017,000
	1975	108,494,000
	1976	117,880,000
Estimated	1977	130,285,000

If the Decision is inconsistent with eligibility for accelerated depreciation, the tax deferrals for the period impacted by the Decision will become currently due and payable.

Determination of the precise period impacted by the Decision requires review of several rate cases. First, the Decision affects rates established by two prior rate orders (Decisions 83162 in 1974 and 85287 in 1975). The rates set by the earlier order first went into effect August 17, 1974. The Decision adjusts the rates back to that date, and thus directly determines the question of eligibility for all periods subsequent to August 17, 1974.

In addition, we believe the Decision determines eligibility for the period from 1970 to August, 1974 as well, although it does not set the rates for that earlier period. Shortly after the

1. The evidence closed in mid-1976 and thus showed actual figures through 1975; however, the Decision used the "most recent estimates" apparently derived from the monthly reports filed by Pacific for 1976, e.g. Exhibit 10, Part 1 and Exhibit B to the Application for Rehearing. The amounts shown relate to the plant used for intrastate services or about 80% of total plant. The FCC's ratemaking is consistent with eligibility as to accelerated depreciation on interstate plant. In re Amendment of Part 31 etc., 24 F.C.C.2d 357 (1970); (Ex. 9, p. 23). The figures used here through 1976 are from Exhibit 10A; 1977 is Pacific's current estimate.

1969 Tax Reform Act went into effect, the Commission, in Pacific's Application No. 51774, held that it would follow the normalization method of accounting required by the federal law with respect to accelerated depreciation.[1] This was reversed[2] and the rates so established were subsequently annulled,[3] so that in the period from 1970 to August, 1974, the rates in effect were *not* based upon normalization. This may well give the IRS grounds for asserting a tax deficiency for this period. However, it may be argued that the Regulations[4] presuppose an initial grace period in which the regulatory Commissions may decide this issue. Thus, even though Pacific's rates were not based on normalization during this initial grace period (1970 through August, 1974), Pacific could still be eligible during the grace period if rates were subsequently set in accordance with eligibility.

There are no decisions involving this grace period and the length of time involved in resolving the matter is troublesome. The Commission has steadfastly held each time the issue was before it that it desired to maintain eligibility and use normalization, and this Court has not held to the contrary. Thus, there has been as yet no final resolution of the ratemaking treatment of accelerated depreciation. If the final decision in this case is consistent with eligibility, we believe that we would be eligible for the entire period since 1970. On the other hand, if this proceeding finally resolves the matter in a manner inconsistent with the requirements of the tax law, there will be little chance to avoid a current obligation for the entire tax liability from 1970 to date.

1. Decision 77984, 71 Cal.P.U.C. 590 (1970).

2. *City and County of San Francisco* v. *PUC*, 6 Cal.3d 119 (1971).

3. *City of Los Angeles* v. *PUC*, 7 Cal.3d 331 (1972).

4. Regs. §1.167(l)-1(h) (4).

The history with respect to the investment tax credit[1] is similar, but there are important distinctions. The ITC came into effect in 1972.[2] The amounts[3] of ITC claimed are:

	1971	$ 8,693,000
	1972	19,369,000
	1973	22,028,000
	1974	24,901,000
	1975	62,157,000
	1976	75,014,000
Estimated	1977	96,454,000

Pacific may only claim the investment tax credit if its rates are made consistent with "Option 2," which permits a ratable flow-through of the credit. The Commission approved this method in 1972 and that Decision became final.[4] The Commission again embraced Option 2 in 1974, but in its 1975 decision this Court directed the Commission to consider the matter further.[5] There is again a distinction between the back tax exposure before and after August 17, 1974. The pre-1974 approval of Option 2 gives comfort, but the legislative history and the statute indicate that any final adjudication that is inconsistent with eligibility destroys eligibility for all open tax years.[6]

The back tax exposure facing Pacific by the end of 1977 with respect to both accelerated depreciation and ITC totals more than $925,000,000; with interest it exceeds one billion dollars.

1. 26 USCA §§ 38, 46.

2. Revenue Act of 1971, 85 Stat. 503, 26 U.S.C.A. § 46.

3. The ITC was initially 4%; in 1975 is was increased to 10%. The amounts shown relate to the ITC associated with plant additions used for intrastate service (about 80% of plant additions); the FCC's rate-making is consistent with eligibility for the ITC associated wtih interstate plant (Ex. 9, p. 23).

4. Decision 79873, 73 Cal.P.U.C. 222 (1972), writ of rev. den. (S.F. No. 22968 and 22969, November 15, 1972).

5. Decision 83162 —— Cal.P.U.C. —— (1974), rev'd in part *City of Los Angeles* v. *PUC*, 15 Cal.3d 680 (1975).

6. I.R.C. § 46(f)(4); Senate Report 92-437, 92d Cong., 1st Session p. 1948 [Exhibit A, Tab 32].

INTERNAL REVENUE SERVICE
DEPARTMENT OF THE TREASURY
Washington, D.C. 20224

Person to Contact: A. L. Woodman

Telephone Number: 202-566-3392

Refer Reply to: T:C:E:A:3

Date: 11 Jan. 1977

Public Service Commission
State of New Mexico
Battan Memorial Building
Santa Fe, New Mexico 87503

Attn: Hon. Richard P. Montoya,
Chairman

Dear Chairman Montoya:

This responds to your December 17, 1976 letter request with related material submitted on behalf of the Commission for a ruling on an issue arising under section 40 of the Internal Revenue Code of 1954 (Code) for which final regulations have not yet been adopted.

The issue involves the proper regulatory accounting treatment for investment credit under section 46(f) of the Code (redesignated from section 46(e) of the Tax Reduction Act of 1975) and is currently pending in a rate regulatory proceeding before the Commission. The proceeding was convened by reason of a petition filed by (company name deleted) for an increase in its service rates subject to the ratemaking jurisdiction of the Commission.

We regret that a ruling as requested cannot be issued. This is because it is the general practice of the Service to rule only under the procedures set out in Rev. Proc. 72-3, (1972-1 C.B. 698), copy enclosed. However, when appropriate and in the interest of sound tax administration, the Service will provide

an information letter in answer to inquiries where it is believed that general information on a particular subject may be of assistance. An information letter does no more than call attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This response is considered to be such a letter.

In your letter, the question involved in stated to be whether or not in the circumstances presented, the Commission may delete from the Company's capital structure the accumulated deferred investment tax credit without resulting in a loss of credit to the Company.

The circumstances are understood to be there. The Company is a "regulated public utility" as defined in section 7701 (a)(33) of the Code: it holds "public utility property" within the meaning of section 46(c)(3) of the Code; certain of the property qualifies for the investment tax credit under the provisions of section 1.46-3(g) of the regulations; and the Company exercised a proper and timely election as provided by section 46(e)(2) (now section 46(f)(2)) of the Code as to the preferred accounting treatment of the credit for ratemaking purposes. The effect of this election from the standpoint of investment tax credit availability is noted in the discussion of the basic question set out in the later part.

It is further understood that in the rate proceeding before the Commission, the Company proposed that for ratemaking purposes, the reserve for accumulated deferred investment tax credit be included with the common stock in th derivation of the Company's composite capital structure for use by the Commission in the determination of an overall rate of return to be applied to the utility rate base. Because the Commission does not contemplate any direct adjustment to the utility rate base, the inquiry centers on the question of whether or not the Company's proposal should be accepted as proper in order that the availability of the investment credit not be jeopardized.

The inquiry is answered in affirmative based upon the effect of the Company's election under section 46(f)(2) of the Code. Upon the exercise of this option, the investment credit is not to be available to a utility with respect to any of its otherwise qualified public utility property if: (a) there is any adjustment to reduce the rate base; or (b) if the credit to which it would otherwise be entitled is flowed through faster than ratably in the period of time over which depreciation expense is computed on the utility's regulated books of account.

In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect a utility's permitted return on investment by treating the credit in any way other than as though it had been contributed by the utility's common shareholders. This means that the cost of capital rate assigned to the credit cannot be less than the rate assigned to the common shareholders' investment. If a lesser rate were to be so assigned, it would be treated as, in effect, a rate base adjustment and the credit would be unavailable.

Accordingly, in determining the overall cost of capital of a utility for ratemaking purposes, deferred investment tax credits are properly to be included and assigned a rate *not less than that considered applicable to common equity.* It follows that the *unamortized investment* credit, or that portion of the credit which has not yet been flowed through to income is appropriately to be included in the total capital of a utility on which a rate of return is to be allowed.

This procedure implements the intent of the Congress that the benefits of the credit be shared between investors and customers. While a utility would be permitted to earn a return on the unamortized investment credit, the ratable amortization of the credit reflected in the utility's cost of service would result in increased revenue for ratemaking purposes with a corresponding reduction in the utility's rates.

Very truly yours,

/s/ GEOFFREY J. TAYLOR
Acting Chief, Engineering and
Valuation Branch